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### Financial Sector Restructuring in Korea

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# **Financial Sector Restructuring in Korea\***

**2003. 11**

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## **Summary**

In response to the adverse development due to the economic crisis of 1997, the Korean government initiated economy wide restructuring in 1998. The economic restructuring drive has been underpinned by what may be called the “four plus one” approach. The “four” means comprehensive restructuring and reforms in the financial, corporate, public and labor sectors. The “plus one” represents the strong commitment of the Korean government to market opening, particularly the liberalization of the capital market and the promotion of foreign direct investment. As of today, assessments vary for the progress and the impact on the national welfare of each of the five restructuring and reforms. However, as far as the financial restructuring is concerned, the consensus view seems to evaluate the Korean case favorably, as the financial system has recovered soundness and back to normal functioning. Given the development, the purpose of this paper is to explain the modality of the financial sector structuring in Korea, to appraise the outcome and to identify economic factors responsible for the outcome.

CHAPTER 1

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**Introduction**

The Korean economy went into turmoil in late 1997 as a currency crisis hit the country. Once occurred, the currency crisis quickly developed into a full-blown banking crisis rendering most of banks and a number of non-banking financial institutions de facto bankrupt. While foreign capital kept flowing out and the financial system became defunct, overall macroeconomic activities shrank drastically. Responding to the adverse development, the Korea government initiated economy wide restructuring in 1998.

The economic restructuring drive has been underpinned by what may be called the “four plus one” approach. The “four” means comprehensive restructuring and reforms in the financial, corporate, public and labor sectors. The “plus one” represents the strong commitment of the Korean government to market opening, particularly the liberalization of the capital market and the promotion of foreign direct investment. In the financial sector, non-viable financial institutions have been closed or merged, while viable institutions cleaned up their balance sheets through recapitalization and the settlement of non-performing loans. Coupled with the restructuring, improving regulatory standards and internal practices has been pursued. In the corporate sector also, non-viable corporations have been pushed to exit at the initiative of creditor banks. For financially distressed but viable corporations, workout programs were devised in partnership with creditor institutions and management. As in the financial sector, along with restructuring measures to improve accounting standards and empower minor stockholders’ rights were taken. At the same time, the labor market has grown in flexibility, with more cooperative relations between labor leaders and management. In the public sector, the government has eliminated red tape, streamlined its organizational framework, and moved ahead on privatizing many state-owned enterprises. And in addition to all of these restructuring efforts, in order to promote inflows of foreign capital, Korea had opened the domestic bond market at the end of 1997 and proceeded to complete the opening of the domestic stock and money markets in early 1998.

As of today, assessments vary for the progress and the impact on the national welfare of each of the five restructuring and reforms. However, as far as the financial restructuring is concerned, the consensus view seems to evaluate the Korean case favorably, as the financial system has recovered soundness and back to normal functioning. Given the development, the purpose of this paper is to explain the modality of the financial sector structuring in Korea, to appraise the outcome and to identify economic factors responsible for the outcome.

The rest of the paper is structured as follows. In section II, I examine the strategy, institutional framework and operational scheme of the financial restructuring that Korea undertook. In section III, progress of the financial restructuring is documented. In section IV, after assessing the financial restructuring, I discuss economic factors accountable for the early resolution.

## **Strategy, Institutional Framework and Operational Scheme of the Financial Restructuring in Korea**

### **II.1.Strategy**

#### **II.1.1. Big Bang**

When a country faces a banking crisis so that a number of financial institutions are near bankrupt, the first decision that the policy maker should draw is between 'gradualism' and 'big bang'. Under the gradualism approach, which is often dubbed as 'forbearance policy', neither injection of new capital into problem financial institutions nor close down of them occurs. Instead failing financial institutions are allowed to continue business despite their balance sheet conditions, while expected to resolve their financial problems by future earnings<sup>1</sup>.

In contrast, the policy maker may prefer the big bang approach and deals with problem financial institutions in the same class at once. In order to pursue the big bang approach, the policy maker is compelled to mobilize public fund and drive the process itself. The government intervention is inevitable, because addressing problems of many financial institutions simultaneously requires large sum of money and entails numerous uncertainties that exceed easily the capacity of private market-driven restructuring. Hence, the big bang approach may be considered as 'public fund based-government driven restructuring'.

Between the two, for the banking sector, it is the big bang approach that the Korean government chose for the restructuring of the Korea financial sector. The government mobilized public fund and began restructuring all the problem commercial banks beginning in June of 1998.

#### **II.1.2. Partial Bail-out: Loss Sharing Rule**

In executing the government-driven restructuring, a difficult question arises for how much of market discipline should be mimicked. Any problem financial institution that fails in attracting new capital should go under, if applying the market solution to the extreme. In that case, all the stakeholders consisting of employed, shareholders and creditors bear expenses of the failure. However, admitting the presence of the system risk, a restructuring plan that allow those financial institutions, that may raise the system risk if closed, to continue their operation may be socially beneficial. But, the social benefits of reducing the system risk is likely to invoke moral hazard as some stakeholders may be bailed out.

Taking this into the account, the Korean government attempted to devise a scheme that could balance between costs and benefits. When the system risk was assessed to be present in association with a financial institution, rehabilitation of the institution was attempted and

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1) Sometimes current shareholders succeed in attracting new investors and in this case, new money comes in. But, even in this case it remains true that the prospect of future earnings dictates new investors' decision.

new capital from public fund injected.<sup>2</sup> Saving some financial institutions, the Korean government sought a way to minimize moral hazard and mimic market discipline to the possible full extent. When providing new capital to failing financial institutions, old shares were destroyed and existing staffs including CEO's harshly displaced. In the end, it was creditors or depositors that received full protection. Other stakeholders paid their bills, and particularly shareholders together with managing staffs took the maximum burden as under close down of institutions.

### **II.1.3. Discretionary Privatization**

As a result of public fund based-recapitalization, the Korean government came to effectively own a number of financial institutions<sup>3</sup>. Given the unintended side-effect of restructuring, shedding government shares emerged as an important policy issue. Essentially, two options existed: 1) privatize as soon as possible; 2) privatize when the government deems it necessary or desirable.

In providing new capital, the Korean government declared that it would seek 'normalization of management' of capital-receiving institutions first, and that privatization would proceed after the normalization. Since it is not clear what constitutes 'normalization of management', the strategy was tantamount to the second option that leaves privatization decision to the discretion of the government.

### **II.1.4. Inclusion of an Industrial Policy objective**

Until the early 1980s, the Korean financial industry was under heavy regulations as competition among financial institutions was strictly restricted. Reflecting the global trend, since the early 1980s the Korean government began deregulating and liberalizing financial institutions and markets. In particular, promoting competition by allowing new entrants became a policy strategy for improving economic efficiency. Thus, seven new banks were chartered over the ten years from the early 1980s to the early 1990s<sup>4</sup>, increasing the number of banks to thirty-three at the end of 1997 when the crisis took place.

Being in contrast against the policy trend, after having experienced the crisis of 1997, the perception that excessive competition had prevailed in the banking industry before the crisis of 1997 evolved among policy makers<sup>5</sup>. As a result, the new industrial policy objective that reduce the degree of competition in the banking industry came to existence in implementing the financial restructuring and the government preferred restructuring schemes that involved M&A's and resulted in larger banks.

## **II.2. Institutional Framework**

### **II.2.1. Regulatory Reform**

#### ***II.2.1.1. Strengthening of the Accounting Standard***

In order to clean up the balance sheet of the financial industry, accurate information on

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2) Unless the system risk was detected, problem financial institutions were closed down.

3) In detail, the KDIC (Korea Deposit Insurance Corporation) operated capital injection and so became the official shareholder of capital-injected institutions.

4) The seven new banks comprise the Shin-Hahn Bank (October 1981), the Hanmi Bank (November 1982), the Dong-Hwa Bank (March 1989), the Dae-Dong Bank (May 1989), the Dong-Nam Bank (June 1989), the Hana Bank (July 1991) and the Boram Bank (September 1991).

5) Policy makers often mentioned about the necessity of establishing leading banks.

the financial state of each financial institution was required in the first place. In this regard, the Korean government introduced reforming regulations of the accounting standard for financial institutions. The first step was made in June of 1998 as standards of asset classification standard and provision requirements were aligned to the best international practices. The asset classification standard was further strengthened in 1999 as forward-looking-criteria (FLC) was adopted, which obliged banks to consider future performance in classifying loans. Another important step in improving the accounting standard was the introduction of the mark-to-market valuation of securities, replacing the book value accounting. Moreover regarding off-balance sheet transactions, the disclosure requirement of the International Accounting Standards was imposed on financial institutions.

Together with upgrading the accounting standard, disclosure rules were improved. Under a new system, the regular disclosure of important balance sheet information including the size of non-performing loans was stipulated to be twice a year, increased from once a year.

**<Table 1> Strengthening of Loan Classification Standards (June, 1998)**

| Classification        | Previous   | New   |
|-----------------------|--|---|
| Normal                | Loans in arrears by less than 3 months             | Loans in arrears by less than 1 months            |
| Precautionary         | Loans in arrears by 3 months to less than 6 months | Loans in arrears by 1 month to less than 3 months |
| Substandard and below | Loans in arrears by no less than 6 months          | Loans in arrears by no less than 3 months         |

### ***II.2.1.2. Introduction of Prompt Corrective Action***

Equipped with accurate information on the financial condition of each financial institution, the government utilized 'prompt corrective action program (PCA program)' as a specific tool in restructuring of individual financial institutions. The PCA program was introduced in 1997 by the enactment of the Financial Industry Structure Improvement Act. The PCA program, imported from the U.S. Federal Deposit Insurance Improvement Act, provides the policy maker with the authority of dictating recapitalization to failing institutions. In the program, three thresh-holds based on the capital condition of a financial institution are stipulated by the regulation. For example, for banks the three thresh-holds consist of 8 percent, 6 percent, and 2 percent of the Basel capital ratio. Whenever the capital condition of a financial institution deteriorates and falls below each thresh-hold, the policy maker can impose an increasingly stringent restructuring measure, including the close down of the institution.

## **II.2.2. Infrastructure Reform**

### ***II.2.2.1. Consolidation of Supervisory Bodies: Creation of the Controlling Agent***

Until the crisis of 1997, Korea had a segmented supervisory system where a separate supervisory body oversaw banking, insurance, and securities business independently. Even before the crisis, caveats of the segmented system drew policy attention and so discussion on reforming the supervisory framework continued. The reforming effort gained



momentum by the eruption of the crisis, and in April 1998 one single agency governing all the supervisory institutions, the Financial Supervisory Commission (FSC), was launched. And in January 1999, the four existing financial supervisory institutions were consolidated under the FSC as the Financial Supervisory Service (FSS) (Figure 1). Not only the sole supervisor authority over the financial industry and markets, but also restructuring power such as operation of the PCA program was granted to the FSC. Thus, the FSC played the central role in the financial restructuring process.

### ***II.2.2.2. Empowerment of the KDIC and the KAMCO: Creation of Restructuring Vehicles***

Korea introduced a public deposit insurance system in December of 1995 by passing the Depositor Protection Act, and following the act the Korea Deposit Insurance Corporation (KDIC) was established in 1996 as the managing agency of the deposit insurance fund. When the financial crisis erupted in 1997, the KDIC lacked resources to deal with the crisis effectively

First of all, according to the original scheme introduced in 1995, deposits were insured only up to 20 million Korean Won. Reflecting the strategy that full protection would be provided to all the depositors during the financial restructuring, the government revised the partial insurance scheme to the full protection in November 1997.

Further, a decision was made that the deposit insurance fund would act as a vehicle, when executing public-fund based recapitalization of a failing financial institution in addition to providing deposit insurance. To carry out the new function, the deposit insurance fund was replenished by issuing the government-guaranteed bond. Also the KDIC was empowered in terms of human resources and legal authority so that it could perform effectively the monitoring role over recapitalized financial institutions.

Another vehicle for the financial restructuring was the Korea Asset Management Corporation (KAMCO). The KAMCO was founded in 1962 as a public enterprise, specializing in resolving bad assets of financial institutions. The Korean government decided to enhance the function of the KAMCO, and in 1998 established the special Bad Debt Resolution Fund. Through the fund, the KAMCO purchased non-performing assets from financial institutions at estimated fair prices and sold the purchased assets in the market after necessary restructuring.

## **II.3. Operational Scheme**

In practice, the resolution process of failing financial institutions was unfolded as follows. 1) If financial institutions fail to satisfy the capital adequacy standard stipulated by the PCA program, the FSS orders submission of self-rehabilitation plan, specifying the source of new capital. 2) The FSS formed an appraisal committee of experts, which evaluates the submitted plan. 3) If the self-rehabilitation plan is not approved, the FSC in consultation with the MOFE designs a resolution package for the financial institution. If system risk is absent, the institution will be closed down or merged by other institutions. In case system risk is present, normalization of business is pursued and financial support is provided. 4) The financial support is made through two channels. The KAMCO purchases non-performing loans, allowing the financial institution to dispose bad assets immediately and focus on normal operation.<sup>6</sup> The KDIC provides new capital after abolishing old shares. 5) The KDIC signs a 'management normalization plan' with new managers of the financial institution that

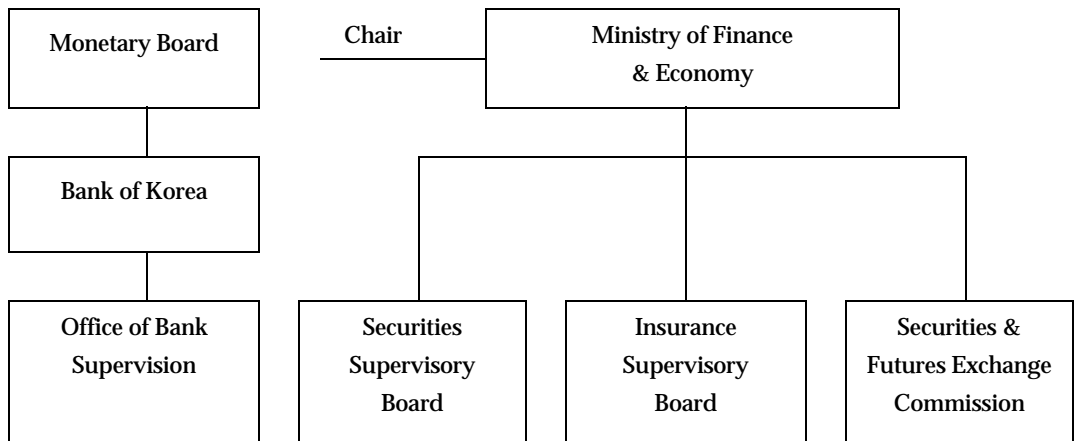
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<sup>6</sup> The KAMCO operation was not only for public fund-based recapitalized institutions. Disposal of bad assets through the KAMCO was made available to all the other financial institutions.

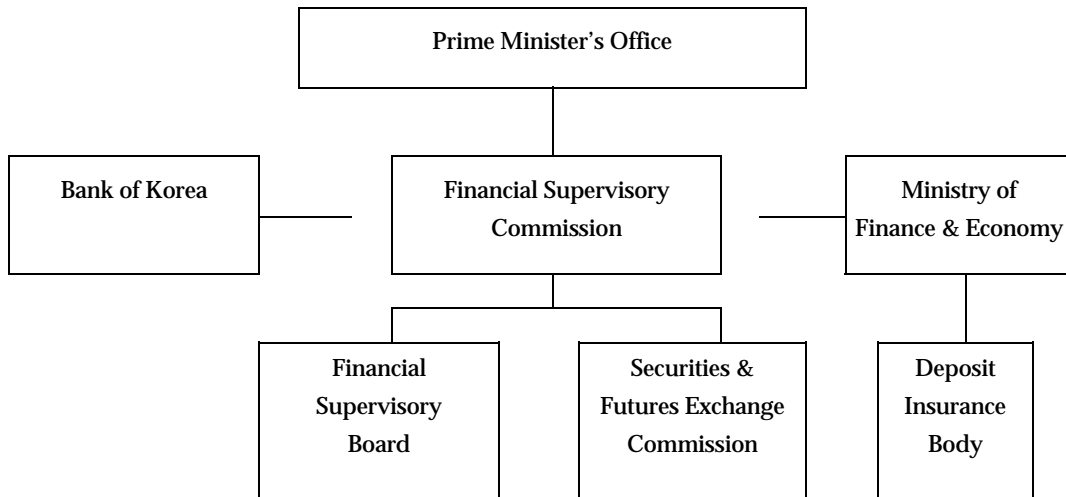
includes management performance measures and detailed restructuring plans. 6) When deemed necessary by the MOFE and the FSC, privatization of the financial institution is sought.

**<Figure 1> Restructuring of the Financial Supervisory System**

**Previous System**



**New System**



Source: Shin and Hahm (1998).

CHAPTER 3

**Progress**

**III. 1. Resolution of Failing Institutions**

**III.1.1. Mobilization of Public Fund**

With the framework in place, the Korean government began financial restructuring in 1998. First of all, in May 1998 the government obtained the approval of the National Assembly to issue government guaranteed bonds, the amount of which reached 64 trillion won, 14.2 percent of 1998 GDP.<sup>7</sup> Part of the fund, 20.5 trillion won, was directed to the KAMCO and for the use of resolving non-performing assets. The rest of the fund, 43.5 trillion won was set aside for recapitalization and depositor protection through the KDIC.

Although in 1998 the government estimated that 64 trillion won would be sufficient for the completion of financial restructuring, in late 1999 it became evident that additional fund was needed. Reflecting the circumstance, in 2000 the National Assembly approved the second round of public fund mobilization for the amount of 40 trillion won. Hence, altogether 104 trillion won of government guaranteed bonds could be issued for financial restructuring, while 102.1 trillion won of bonds has already been issued (Table 2). Also it should be noted that gross amount used in financial restructuring with initially mobilized by bond issuance exceeds the net amount of bond issuance, because those fund that recouped from the initial use was permitted to be re-spent on financial restructuring.

**<Table 2> Fiscal Support (as of June, 2002)**

(Unit : Trillion Won)

| Use<br><br>Source           | KDIC and Others      |                      |                   |                                  | KAMCO                             | Total        |
|-----------------------------|----------------------|----------------------|-------------------|----------------------------------|-----------------------------------|--------------|
|                             | Equity Participation | Capital Contribution | Insurance Payment | Purchase of Assets <sup>1)</sup> | Purchase of Non-Performing Assets |              |
| Bond Issuance <sup>2)</sup> | 46.1                 | 16.4                 | 26.0              | 8.6                              | 37.2                              | 134.3        |
| (Responding) <sup>3)</sup>  | (3.9)                | (1.2)                | (6.0)             | (4.4)                            | (16.7)                            | (32.2)       |
| Others                      | 14.1                 | -                    | 0.5               | 6.3                              | 1.5                               | 22.4         |
| <b>Total</b>                | <b>60.2</b>          | <b>16.4</b>          | <b>26.5</b>       | <b>14.9</b>                      | <b>38.7</b>                       | <b>156.7</b> |

Note: 1) Includes purchase of subordinated bonds.

2) Includes responding

3) Spending of recovered fund from the initial use

Source : Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Fund, 2002.

7) Out of 64 trillion won, 38.8 trillion won was mobilized and used in 1998, while remaining 25.2 trillion won of bonds was issued in 1999.

In addition to the fund based on bond issuance, the government utilized funds from other sources such as government owned equities that reached 22 trillion won. In total, as of June 2002, the amount of public fund expended for financial restructuring reached 156.7 trillion won.

### **III.1.2. Resolution of Distressed Financial Institutions**

On April 14, 1998, the Korean government announced that it would complete banking sector restructuring by the end of August 1998, and the non-banking sector by the end of September 1998. According to the plan, in April the FSC ordered the twelve commercial banks that failed to meet the BIS capital ratio of 8 percent to submit rehabilitation plans. In June, after assessing the rehabilitation plans, five small banks were found non-viable and their rehabilitation plans rejected. The FSC ordered the five banks to close down and transfer their assets and liabilities to relatively sound banks under a purchase and assumption (P&A) arrangement<sup>8</sup>. Remaining seven banks' rehabilitation plans were approved conditioned on the progress of internal restructuring and the public-fund based assistance, as their close down would entail system risk. The FSC replenished capital base of the seven banks through the KDIC and disposed their non-performing assets through the KAMCO. Later as a restructuring measure, M&A's among the seven banks were promoted, resulting in three larger banks<sup>9</sup>. In fact, even relatively sound banks such as Kookmin and Korea Housing Bank were encouraged to consolidate. As a result, as of June 2002, the number of commercial banks sharply decreased to twenty from thirty-three in 1997 (Table 3).

The restructuring of non-bank financial institutions (NBFIs), including insurance companies, merchant banking corporations, and investment trust companies, proceeded in principle under majority shareholders' responsibility. This was so because most of NBFIs were presumed free from system risk. If an institution failed to meet the standard in the PCA program, the institution was ordered to restore its financial viability through recapitalization. If it failed to rehabilitate, the FSC decided close down of the institution.

An exception to this rule was Korean Investment Trust Company and Daehan Investment Trust Company. Being the two largest investment trust companies, drastic restructuring of the two companies such as suspension and close down was considered to invoke system risk. Thus, public fund based rehabilitation was applied to the two companies in late 1999.

## **III. 2. Cost of Restructuring**

As of June 2002, out of 156.7 trillion won that directed toward financial restructuring, 41.9 trillion won has been recouped. According to the government, additional 40.7-48.7 trillion won is estimated to be recovered. Therefore, the recovery ratio is expected to reach around 55 percent (Table 4).

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<sup>8</sup>) The pairs of five suspended banks and their acquiring banks to assume the assets and liabilities are Daedong-Kookmin, Dongnam-Housing & Commercial, Donghwa-Shinhan, Kyungki-KorAm, and Chungchong-Hana Banks, respectively.

<sup>9</sup>) Woori (Korea Commercial Bank, Hanil Bank, Peace Bank), Choheung Bank (Choheung Bank, Kanwon Bank, Chungbuk Bank) and Korea Exchange Bank.

**<Table 3> Restructuring of Financial Institutions (as of June 2002)**

|                                     | No. of Institutions (end of 1997) (A) | Restructuring    |        |             |           |                | New Entry | No. of Institutions (end of 1997) (A) |
|-------------------------------------|---------------------------------------|------------------|--------|-------------|-----------|----------------|-----------|---------------------------------------|
|                                     |                                       | Licenses Revoked | Merger | Dissolution | Total (B) | Ratio(%) (B/A) |           |                                       |
| Bank (C)                            | 33                                    | 5                | 9      | -           | 14        | 42.4           | 1         | 20 <sup>1)</sup>                      |
| Merchant Bank                       | 30                                    | 18               | 6      | 4           | 28        | 93.3           | 1         | 3                                     |
| Securities Companies                | 36                                    | 5                | 2      | 1           | 8         | 22.2           | 16        | 44                                    |
| Insurance Companies                 | 50                                    | 7                | 6      | 2           | 15        | 30.0           | 9         | 44                                    |
| Investment And Trust Companies      | 30                                    | 6                | 1      | -           | 7         | 23.3           | 8         | 31                                    |
| Mutual Saving and Finance Companies | 231                                   | 74               | 27     | 25          | 126       | 54.5           | 12        | 117                                   |
| Credit Unions                       | 1,666                                 | 2                | 102    | 319         | 423       | 25.4           | 9         | 1,252                                 |
| Leasing Companies                   | 25                                    | 9                | 1      | -           | 10        | 40.0           | 4         | 19                                    |
| Non-Bank (D)                        | 2,068                                 | 121              | 145    | 351         | 617       | 29.8           | 59        | 1,510                                 |
| Total(C+D)                          | 2,101                                 | 126              | 154    | 351         | 631       | 30.0           | 60        | 1,530                                 |

Note : 1) Would be '17' if banks under the same financial holding company is counted as one.

Source: Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Fund, 2002.

**<Table 4> Estimated Recovery Ratio of Public Fund (as of June 2002)**

(unit : trillion won)

| Total Expenditure | Recovered | To be Recovered (Estimated) | Recovery Ratio       |
|-------------------|-----------|-----------------------------|----------------------|
| 156.7(A)          | 41.9(B)   | 40.7-48.7(C)                | 52.7-58.0% <(B+C)/A> |

Source : Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Fund, 2002.

### III.3. Impact on the Financial Industry

#### III.3.1. Soundness

##### III.3.1.1. Non-performing assets

As a result of financial restructuring, non-performing assets of the financial industry have decreased significantly. Focusing on the banking sector, ratio of non-performing loans

was hovering around 8.3 percent in 1999 when restructuring efforts just began. As restructuring proceeded, the ratio came down to 6.6 percent in 2000 and further decreased to 1.9 percent in 2002 (Figure 2).

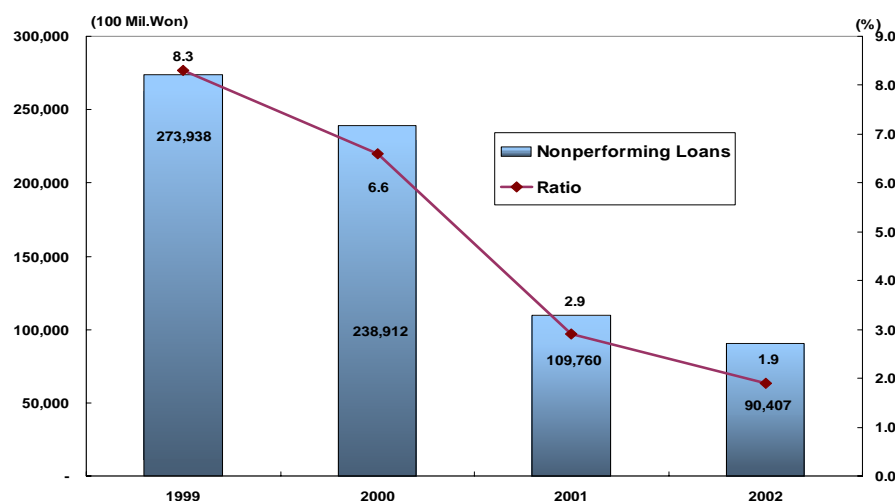
### III.3.1.2. Capital Condition

Recapitalization together with resolution of non-performing loans improved capital strength of financial institutions rapidly. Focusing on the banking sector, in 1997 the average BIS capital ratio of Korea's commercial banks was 7.04 percent, failing to meet the minimum standard of 8 percent. However, as restructuring began in 1998, the BIS capital ratio jumped to 8.23 percent in 1998 and recorded another substantial increase to 10.83 percent in 1999. Since then, the ratio has stabilized at over 10 percent (Figure 3).

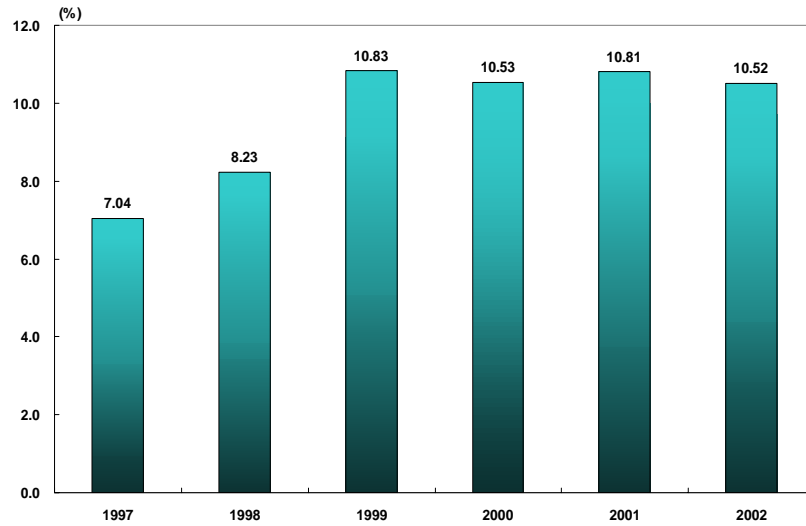
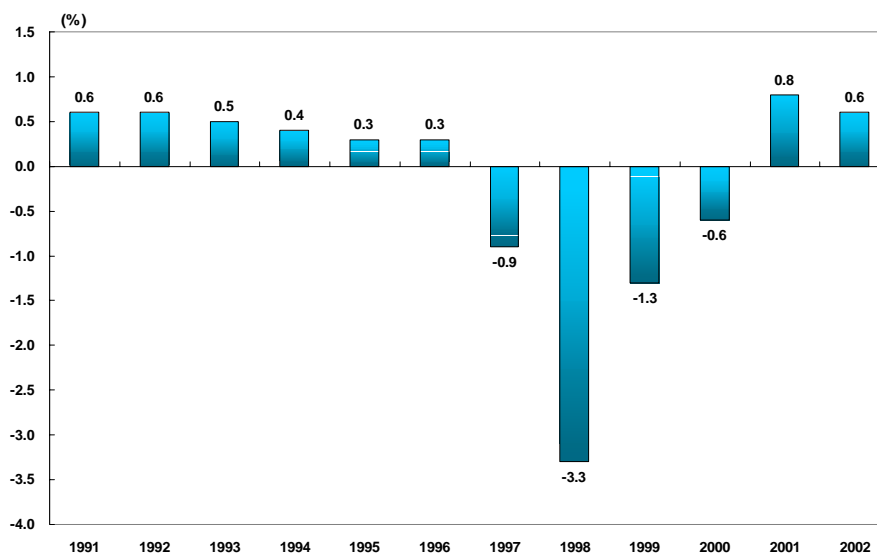
### III.3.1.3. Profitability

Not only balance sheets have been cleaned up, but also banks' profitability has improved notably. Even well before the crisis of 1997, Korea's banks suffered from low profitability<sup>10</sup>. Banks' profitability began dwindling in 1993 and kept falling during the years of 1994 and 1995 despite the economic boom, threatening the long-term stability of the industry. The outbreak of the crisis in 1997 only worsened the situation. In 1998 as the Korean economy slipped into a severe recession, profitability of banks measured by ROA dropped to -3.3 percent, a historical low. As the government driven restructuring had been on the way since 1998, profitability of banks began improving. Finally, in 2001 ROA of banks fully recovered, registering 0.8 percent. The strength of profitability continued in 2002 as ROA recorded sound 0.6 percent (Figure 4).

<Figure 2> Non-performing Loans of Banks



10) For the detailed discussion on this, see Dooley and Shin (2000).

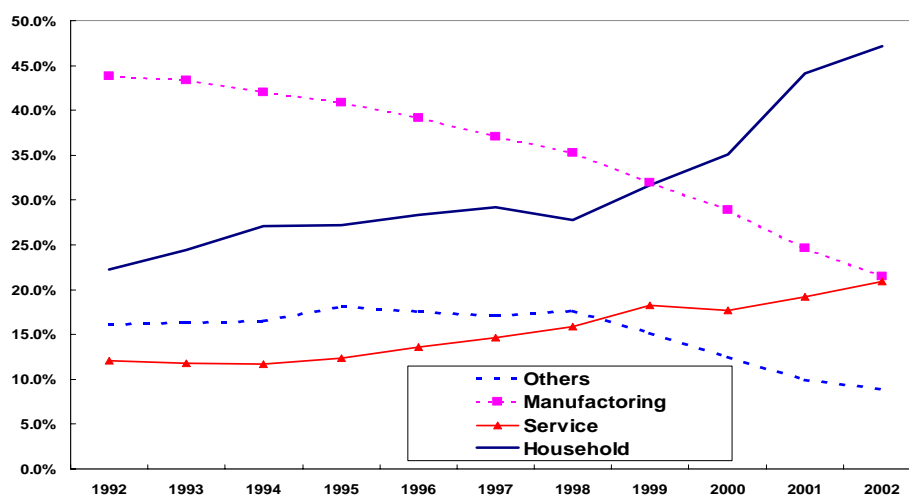
**<Figure 3> BIS Capital Ratio of Banks****<Figure 4> Profitability of Banks (ROA)**

### III.3.2. Portfolio Structure

Recovery of banks was accompanied by a major change in loan portfolio. During Korea's economic development era, banks channeled funds to large manufacturing companies, while many of them were members of *Chaebols*, Korean conglomerates. However, after the crisis, lending directed to manufacturing companies has been on a

decreasing trend. In contrast, lending to households, which had explained less than 30 percent of the total loans before the crisis, has been surging and reached near 50 percent in 2002. (Figure 5)

<Figure 5> Loan Portfolio Structure of Banks



### III.3.3. Competition Structure

As the Korean government encouraged M&A's during the restructuring, the banking industry has become much more concentrated. The first critical event was the merge between Korea Commercial Bank and Hanil Bank, creating Woori Bank. The second wave came when Kookmin Bank and Korean Housing & Commercial Bank merged. In the end, Korea's banking industry became quite concentrated, as CR 5 ratio rose substantially to 72.2 percent in 2002 from 47.6 percent in 1998 (Table 5).

<Table 5> Concentration Ratio of the Korean Banking Industry

|                     | End of 1998 | End of 1999 | End of 2000 | End of 2001 | End of 2002 |
|---------------------|-------------|-------------|-------------|-------------|-------------|
| CR <sub>1</sub> (%) | 10.9        | 13.4        | 14.5        | 28.2        | 26.5        |
| CR <sub>3</sub> (%) | 31.6        | 38.8        | 42.1        | 55.5        | 53.8        |
| CR <sub>5</sub> (%) | 47.6        | 58.1        | 60.8        | 70.7        | 72.2        |

Note : Based on total loan.

Source : Bank of Korea.



## CHAPTER 4

# Assessment and Discussion

### IV.1. Assessment

In the following aspects, the Korean financial sector restructuring was successful. First, distressed financial institutions were resolved quickly, presumably reducing cost of restructuring. It is widely argued that forbearance policy increases cost of restructuring because distressed financial institutions tend to be run inefficiently due to distortion in managerial incentive system. To the extent that this argument is correct, early resolution of problem institutions should be regarded desirable.

Secondly, adverse impacts on the real economy from the restructuring appear to have been avoided. The Korean economy experienced a severe recession in 1998 that started in late 1997 as a repercussion to the currency crisis. But, when the government-driven financial restructuring proceeded in late 1998, the Korean economy began recovery, registering over 10 percent GDP growth in 1999. This macroeconomic development suggests that the financial restructuring initiated in 1998 did not take significant negative effects on the economy, and much worried credit crunch did not materialize. Notably, among five Asian countries affected by the Asian crisis of 1997 (Indonesia, Korea, Malaysia, Philippines, and Thailand), all other countries except Korea experienced reduction in real domestic credit<sup>11</sup>.

Whether the industrial policy initiative of fostering leading banks was effective and welfare-enhancing is yet to be seen. In general, increase in concentration rate of the banking industry is likely to raise the stability of financial system at the expense of efficiency<sup>12</sup>. Though preliminary studies found no evidence that the Korean banking industry has become less competitive after the restructuring<sup>13</sup>, it is too early to draw conclusive appraisal.

### IV.2. Discussion: Economic Factors for the Early Resolution

#### IV.2.1. Early Macroeconomic Recovery

The foremost factor favorable for the Korean financial restructuring was quick macroeconomic turnaround that prevented distress of financial institutions from worsening. Then, what made the early macroeconomic revival possible? Some argue that initial policy responses were appropriate. Short-term external debt rescheduling in February accelerated foreign exchange market stability. And the U-turn in macroeconomic policy stance in mid 1998 provided momentum for economic recovery.

Aside from the policy factors, two economic factors may be important for the post-crisis

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11) Hong and Tornell (2000).

12) Bordo, Redish and Rockoff (1995) discuss this issue in the context of the US and Canadian Banking system.

13) Kim (2003)

macroeconomic adjustment<sup>14</sup>. The first one involves the nature of the Korean crisis. Many

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<sup>14</sup> This part relies on Cho and Rhee (1999), Hong and Tornell (2000), and more generally Gourinchas, Valdes and Landerretche (1999).

studies document that the initial investment boom and real appreciation of the Korean Won before the crisis were modest. Also pre-crisis credit growth was rather stable. Stylized facts on post-crisis macroeconomic development show that when the degree of pre-crisis boom is low, afterwards recovery tends to be quick. Hence, the relatively fast recovery of the Korean economy may have been predetermined by the nature of the crisis. The second one to note is stable foreign environment. During post crisis years, interest rates and GDP growth rates of major economies in the World remained quite favorable to Korea. In particular, without strong growth and interest rate cuts in the US, recovery of the Korean economy might have been delayed.

#### IV.2.2. Balanced Financial Structure

After the Asian crisis of 1997, some argue that the imbalanced financial market structure tilted toward the bank system in Asian countries may have prolonged underdevelopment of the financial system and exacerbated credit crunch after the crisis. In light of the argument, it is notable that unlike most of other Asian countries, the corporate bond market in Korea had already displayed strong growth since the late 1970s so that bonds explained about sixteen percent of corporate external financing in stock in 1997 (Table 6).

Further, while the banking sector underwent large scale restructuring in 1998, issuance of corporate bonds swelled. Part of the issuance was by near bankrupt companies like Daewoo, and so became a source of another turmoil in 1999<sup>15</sup>. Nonetheless, the existence of corporate bond market seems to have mitigated credit squeeze owing to the banking sector restructuring, making a positive contribution to the real economy.

<Table 6> External Financing of Non-Financial Firms: Composition of Stock

(Average, %)

|           | 1976-80 | 1981-85 | 1986-90 | 1991-95 | 1996  | 1997  | 1998  | 1999  |
|-----------|---------|---------|---------|---------|-------|-------|-------|-------|
| Bond      | 3.3     | 7.2     | 10.1    | 15.5    | 16.2  | 16.1  | 21.0  | 20.4  |
| Equity    | 17.8    | 16.1    | 18.6    | 17.9    | 16.2  | 15.4  | 17.0  | 20.3  |
| CP        | 1.4     | 3.0     | 4.0     | 5.2     | 8.6   | 7.4   | 6.1   | 4.2   |
| Sub Total | 22.5    | 26.3    | 32.7    | 38.6    | 41.0  | 38.9  | 44.1  | 44.8  |
| Loans     | 29.7    | 33.5    | 36.1    | 37.5    | 36.0  | 36.1  | 33.3  | 32.1  |
| Foreign   | 13.6    | 10.9    | 6.2     | 4.4     | 5.7   | 8.5   | 5.8   | 5.4   |
| Others    | 34.3    | 29.3    | 25.1    | 19.5    | 17.3  | 16.6  | 16.9  | 17.7  |
| Total     | 100.0   | 100.0   | 100.0   | 100.0   | 100.0 | 100.0 | 100.0 | 100.0 |

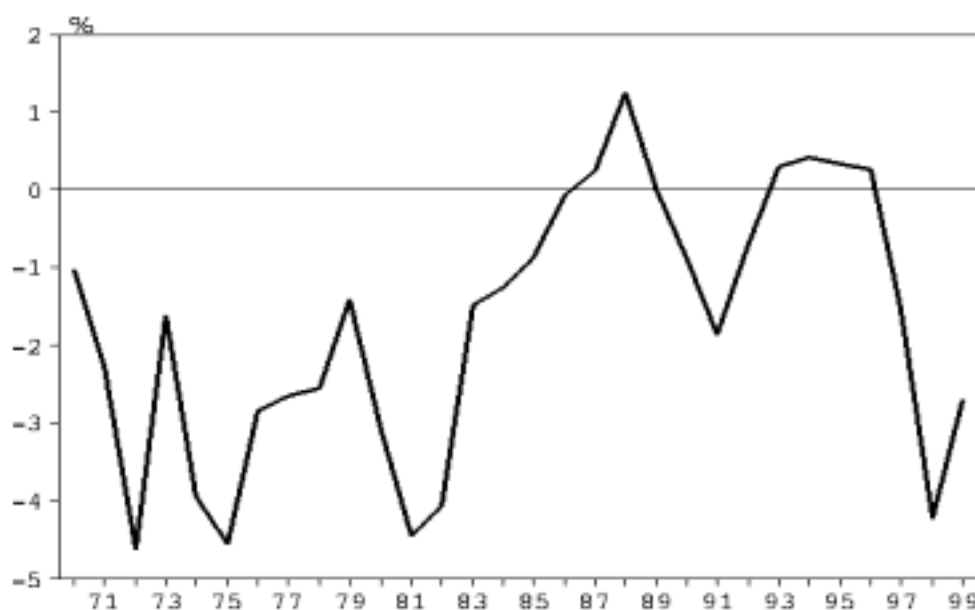
Source: Shin (2001)

15) For this, see Shin (2001)

### IV.2.3. Sound Fiscal Condition

In the late 1970s, fiscal imbalance and inflationary bias haunted the Korean economy coupled by oil price shocks. Recognizing that without establishing fiscal discipline long term economic stability could not be sustained, the Korean government pursued aggressive fiscal reform in tandem with monetary reform in the early 1980s. Many tax incentives supporting strategic industries were phased out, and the zero-base principle was applied to the budget planning. As a result the consolidated budget deficit gradually approached to a balance, and from then on the balanced-budget policy became a tradition in the fiscal body and a highly praised aspect of the Korean economy (Figure 6)<sup>16</sup>. When the crisis of 1997 occurred and resolution of distressed financial institutions demanded policy intervention, presumably the Korean government was able to respond to the call quickly and mobilize the large amount of public fund because Korea's fiscal balance sheet had been maintained sound.

**Figure 6. Consolidated Budget Balance (percent of GDP)**



Source : Monthly Financial Statistics Bulletin, Bank of Korea.

### IV.2.4. Sound Financial Condition of the Household Sector

Sometimes macroeconomic recovery does not guarantee the improvement of profitability of the financial sector, where Mexico after the Crisis of 1994 is a case in point<sup>17</sup>. Mexican economy achieved sharp recovery in 1996, after suffered only one-year recession. However, non-performing loans in the banking sector actually kept increasing, and

<sup>16</sup> For Korea's macroeconomic reform in the early 1980s, see Kim and Shin (2003).

<sup>17</sup> Krueger and Tornell (2002).

moreover the banking sector stopped normal functioning while bank loans in real terms kept shrinking. The recovery under declining bank loans was possible because the exporting sector switched to foreign financing in the international capital market as its financing channel. The Mexican case shows that banks can convert macroeconomic recovery into their profitability increase only if they can find suitable borrowers. In this context, it should be re-emphasized that profitability of Korean banks has improved based on the expansion of business toward the household sector. Households in Korea could increase leverage because historically financial indebtedness of households had been low (Table 7). In short, the existence of financially sound agents, namely consumers, filled the gap in credit demands created by financial distress of the corporate sector, and helped banks recover.

**<Table 7> Financial Indebtedness of Korea's Household**

|       |                            | 1981 | 1986 | 1991 | 1996 | 1997 | 1998 | 1999 | 2000  |
|-------|----------------------------|------|------|------|------|------|------|------|-------|
| Korea | Ratio to GDP               | 19.3 | 28.2 | 43.5 | 51.3 | 54.5 | 50.9 | 50.5 | 56.2  |
|       | Ratio to Disposable Income | 28.0 | 42.0 | 63.4 | 77.5 | 82.5 | 71.9 | 75.7 | 86.9  |
| US    | Ratio to GDP               | 48.4 | 57.2 | 63.7 | 66.9 | 66.9 | 68.5 | 70.6 | 72.1  |
|       | Ratio to Disposable Income | 67.4 | 78.1 | 85.2 | 92.0 | 93.1 | 94.8 | 98.8 | 102.2 |

Source : Shin and Park (2002).

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