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### Korean Bank Recapitalization Fund

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# Korean Bank Recapitalization Fund

Lily S. Engbith<sup>1</sup>

June 13, 2018

## Abstract

Following the collapse of Lehman Brothers on September 15, 2008, a number of foreign governments enacted stabilization measures in order to protect their domestic economies in the wake of the global credit crunch. The Bank Recapitalization Fund ('the Fund'), announced by the Korean government on December 18, 2008, and implemented on February 15, 2009, was one such intervention intended to assist Korean commercial banks in strengthening their capital bases and thus restore normal lending practices between banks and non-financial institutions. Invoking its authority under Section 6, Article 80 of the Operations of the Bank of Korea, the government committed up to KRW 20.0 trillion (KRW 1.0 = 0.00097 USD) for the purchase of preferred shares, hybrid securities, or subordinated debt from participating banks. Each bank wishing to utilize the fund would be required to sign with the Korean government a Memorandum of Understanding (MoU) stating its commitment to using the funds gained from the sales to support the real economy. Continued individual usage, interest rates, and restrictions would be determined based on the institution's adherence to the MoU terms. On March 31, 2009, the Fund purchased approximately KRW 4.0 trillion in hybrid securities and subordinated debt from eight Korean banks. By December 2011, the government had recovered KRW 2.8 trillion through bond sales and bank buyback arrangements.

**Keywords:** Recapitalization, capital injection, capital adequacy ratio, Korea

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# Korean Bank Recapitalization Fund

## At a Glance

In the wake of Lehman Brothers' collapse on September 15, 2008, governments around the world enacted stabilization measures in order to protect their domestic economies from the massive disruption in global credit markets. Among them, the Republic of Korea sought to implement a series of short-term interventions that would both boost liquidity and restore healthy lending between banks and non-financial institutions, particularly small and medium enterprises (SMEs). One such program was the Bank Recapitalization Fund ('the Fund'), announced on December 18, 2008, and implemented on February 15, 2009, as part of the Financial Services Commission's (FSC) plan of action in response to the Global Financial Crisis.

Invoking its authority under Section 6, Article 80 of Chapter IV of the Operations of the Bank of Korea, the Korean government committed up to KRW 20.0 trillion (KRW 1.0 = 0.00097 USD) for the purchase of preferred shares, hybrid securities, or subordinated debt from Korean commercial banks. The funds were to be raised from a combination of both private and public sources – KRW 10.0 trillion from the Bank of Korea, 2.0 trillion from Korea Development Bank, and 8.0 trillion from institutional and private investors.

Korean commercial banks wishing to participate in the Fund would be required to sign with the Korean government a Memorandum of Understanding (MoU) stating their commitment to assisting the real economy. Progress – or lack thereof – toward these objectives would determine individual usage caps, interest rates, and other restrictions. After having received approval from the FSC, banks could then access the fund on a capital call basis when in need of liquidity.

On March 31, 2009, the Fund initiated its first round of bond purchases – KRW 3.5 trillion in hybrid securities with 30-year maturities and KRW 0.5 trillion in subordinated debt with maturities of five years and nine months – from eight banks. By the end of November 2011, a total of KRW 1.3 trillion had been repaid through the combined sale of KRW 503 billion in subordinated securities on the open market and KRW 0.8 trillion in hybrid security buybacks by the issuing banks. On December 9, 2011, the government initiated an early repayment scheme whereby banks would be allowed to buy back their hybrid securities before maturity. A total of KRW 1.5 trillion was recovered through this process, leaving a total of KRW 1.2 trillion to be repaid to the government.

## Summary Evaluation

The Korean government viewed the early repayment scheme as an indication of the Fund's success in helping banks to recover from the negative impact of the Global Financial Crisis. However, a report by the National Assembly Budget Office noted that the FSC had not done enough to destigmatize use of the program, as many of the stronger banks had already raised their Tier 1 capital ratios by the time the Fund had become operational.

### Summary of Key Terms

**Purpose:** To strengthen the capital base of banks in order to encourage lending to non-financial institutions, particularly SMEs, through the purchase of preferred shares, hybrid securities, or subordinated debt from Korean commercial banks

**Announcement Date** December 18, 2008

**Operational Date** February 15, 2009

**Expiration Date**

**Legal Authority** Section 6, Article 80 of Chapter IV of the Operations of the Bank of Korea

**Budget** KRW 20.0 trillion

**Peak Utilization** KRW 4.0 trillion

**Overseer** Financial Services Commission; Bank Recapitalization Oversight Committee

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# I. Overview

## Background

Due to its success in overcoming the market volatility caused by the Asian Financial Crisis of 1997, the Republic of Korea was thought to have been relatively more prepared than its Western counterparts to manage the economic fallout from the Global Financial Crisis (Rhee 2008). Despite having strengthened its regulatory institutions and policies, however, Korea was greatly impacted by the subprime mortgage downturn in 2007. This was partially due to the fact that during the first half of 2008, overseas lenders collectively withdrew \$886 million and net foreign direct investment turned negative for the first time since 1980 (Fackler 2008). Such a large divestment would later exacerbate Korea's inability to repay its external debts and, consequently, the relatively stable economy remained vulnerable to exogenous shocks (Harden 2008).

The summer of 2008 brought with it a precipitous decline in confidence as the stock market dropped 38% and the Korean won fell 30% against the dollar (Harden 2008). In alarmed response, both banks and major corporations, such as Hyundai and Samsung, began hoarding domestic currency (Harden 2008, Sang-Hun 2008). The failure of Lehman Brothers on September 15 aggravated matters considerably, sending global credit markets into chaos and driving further anxieties over the strength of Korea's export markets and foreign currency reserves (Fackler 2008). As the state of the broader economy worsened, individual domestic banks began to experience the effects of the crisis more directly. Woori Bank, one of Korea's largest lenders, faced a serious liquidity shortage when overseas banks began to refuse to roll over many existing loans and instead insisted that Woori pay its maturing obligations in dollars (Fackler 2008). The government responded by supplying the bank with \$280 million in dollar loans.

This lending crisis spread rapidly as investors lost confidence in Korean banks' abilities to honor their maturing foreign currency loans. Following the collapse of Lehman, capital outflows totaled \$42.8 billion between 4Q2008 and 1Q2009 (Kim 2009). Such a large selloff, coupled with the depreciation of the won and rising borrowing costs, caused Moody's to declare Korea to be "one of the few banking systems in Asia where domestic deposits are insufficient to fund loans" (Sang-Hun 2008). Furthermore, S&P downgraded the Big Four Korean banks – Kookmin Bank, Woori Bank, Shinhan Bank, and Hana Bank – from 'stable' to 'negative' on October 1. Their ability to raise foreign capital thus continued to decline (Gup 2010).

Having relatively recently opened its market to the international community, Korea did not have access to the same emergency sources of foreign currency reserves as did other countries (Fackler 2008). It was also more susceptible to market instability due to its transparency and openness to foreign investment (Fackler 2008). In response to the deleterious effects of the Global Financial Crisis, the Korean Financial Services Commission (FSC) sought to calm and protect domestic markets by proposing a comprehensive set of stabilization measures to be enacted throughout 2009. While other interventions, such as the State Guarantee of External Debt of Korean Banks (see Engbith 2018), had been

announced previously in October 2008, the government designed a coordinated response to address the ongoing market volatility. Aside from the Bank Recapitalization Fund, the new plans provided for the establishment of the Bond Market Stabilization Fund, the Stock Market Stabilization Fund, and the Bank Capital Expansion Fund. The FSC also issued new guidelines for the restructuring of distressed companies and tightened supervision of the financial derivatives market.

### **Program Description**

On December 18, 2008, the FSC released its agenda and recommendations for the upcoming 2009 fiscal year. Included in those plans was a provision for the creation of the Bank Recapitalization Fund ('the Fund'), an intervention designed to assist Korean commercial banks in replenishing capital and lending to the domestic economy by raising capital adequacy ratios by 1.5%. Officially implemented on February 15, 2009 and jointly administered by the FSC and the Bank Recapitalization Oversight Committee, the Fund was founded under the legal authority granted by Article 80 ("Credits to Profit-Making Enterprises"), of Chapter IV of the Operations of the Bank of Korea. Importantly, its establishment would allow the government to strengthen the capital base of all banks – even those meeting the BIS capital requirements of 9% – in order to encourage lending to non-financial institutions, particularly small and medium enterprises (SMEs), through the purchase and resale of preferred shares, hybrid bonds, or subordinated debt from Korean commercial banks.

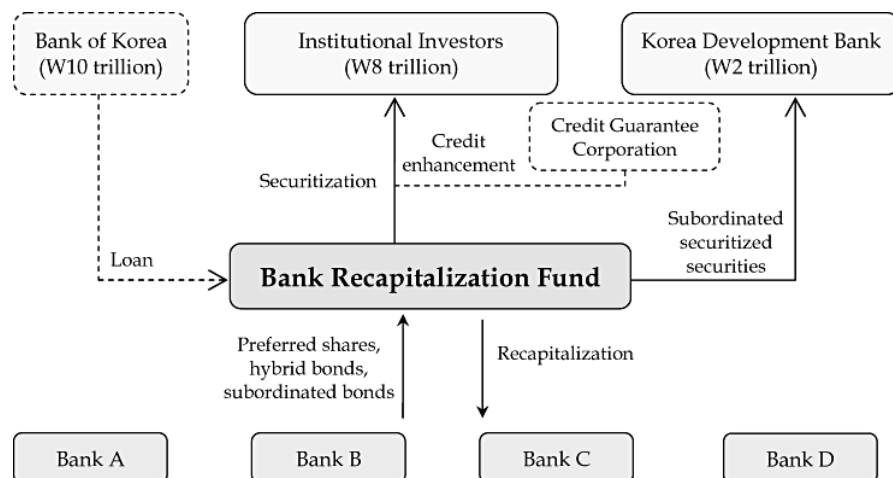
The Korean government committed up to a total of KRW 20 trillion<sup>2</sup> (2% of GDP) for Fund purchases. This proposed total comprised a KRW 10 trillion loan from the Bank of Korea and an additional KRW 2 trillion from Korea Development Bank. The government intended to raise the final KRW 8 trillion by purchasing banks' subordinated debt and hybrid securities through the Fund and selling them to institutional investors in the form of securities.

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### **Figure 1: Interest Rates Charged According to Bank Size and Rating**

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<sup>2</sup> KRW 1.0 = 0.00097 USD



Source: Lee and Rhee 2012

Participation in the Fund was open to all Korean commercial banks, both regional and national. Preferred shares, hybrid securities, and subordinated debt were eligible for issuance to the Fund by participating banks. In order to reduce stigma, individual caps on usage were imposed based on a bank’s asset holdings rather than credit ratings (Lee and Rhee 2012). In order to apply for access to the Fund, a bank would be required to sign with the FSC and the Bank Recapitalization Oversight Committee an implementation Memorandum of Understanding (MoU) specifying particular commitments to providing liquidity support to the real economy, SMEs, and corporate restructuring programs. The FSC would then continually monitor each institution’s progress with respect to the MoU obligations and adjust any government support accordingly. For instance, a bank that did not demonstrate clear progress toward supporting the real economy could face limited access to the Fund and higher applicable interest rates in subsequent rounds of bond purchases.

### Outcomes

Prior to the first round of bond purchases, the FSC undertook a review of all Korean commercial banks to assess their compliance with the MoU terms. Six banks received ‘excellent’ ratings, while the remaining eight were rated as ‘satisfactory.’ An interest rate of 6.59% would be imposed on nationwide banks with an ‘excellent’ rating issuing hybrid securities, while those deemed to be ‘satisfactory’ would incur an additional 30 basis points (6.89%). Similarly, nationwide banks with ratings of ‘excellent’ issuing subordinated debt would be charged an interest rate of 6.49%, while ‘satisfactory’ banks were charged at a rate of 6.59%. To account for the discrepancy between regional and nationwide banks’ credit ratings, regional banks would be charged an additional 30 basis points on top of their larger counterparts’ rates (“Bank Recapitalization Fund Oversight Committee’s Third Execution Blueprint”).

**Figure 2: Interest Rates Charged According to Bank Size and Rating**

	<b>Nationwide Banks (Excellent)</b>	<b>Regional Banks (Excellent)</b>	<b>Nationwide Banks (Satisfactory)</b>	<b>Regional Banks (Satisfactory)</b>
<b>Hybrid securities</b>	6.59%	6.89%	6.89%	7.19%
<b>Subordinated debt</b>	6.49%	6.79%	6.59%	6.89%

Source: Financial Services Commission 2011

On March 31, 2009, the Fund purchased from eight Korean banks KRW 3.5 trillion in hybrid securities with maturities of 30 years and KRW 0.5 trillion in subordinated debt with maturities of five years and nine months. This was the sole round of purchases conducted by the Fund. The following table details the issuances by bank:

**Figure 3: Bank Recapitalization Fund Purchases as of March 31, 2009**

Type/Banks	Woori Financial Holdings	Woori Bank	Kookmin Bank	Hana Bank	NH Bank	Suhyup Bank	Kyongnam Bank	Kwangju Bank	Total
<b>Hybrid securities</b>	-	1,000	1,000	400	750	100	116	87	3,453
<b>Subordinated debt</b>	300	-	-	-	-	-	116	87	503
<b>Total</b>	<b>300</b>	<b>1,000</b>	<b>1,000</b>	<b>400</b>	<b>750</b>	<b>100</b>	<b>232</b>	<b>174</b>	<b>3,956</b>

Note: Amounts denominated in KRW, billions

Source: Financial Services Commission 2011

By the end of November 2011, a total of KRW 1.3 trillion had been repaid through the combined sale of KRW 503 billion<sup>3</sup> in subordinated securities on the open market and

<sup>3</sup> Kyongnam, Kwang-Ju (KRW 203 billion, Mar. 2010), Woori Financial Holdings (KRW 300 billion, Dec. 2010)



KRW 0.8 trillion<sup>4</sup> in hybrid security buybacks by issuing banks (“Early Repayment of Bank Recapitalization Fund”).

On December 9, 2011, the Bank Recapitalization Oversight Committee approved the implementation of an additional early repayment scheme whereby issuers would be able to buy back their hybrid securities before maturity. This arrangement allowed four banks<sup>5</sup>, whose earnings had increased over the course of 2011, to purchase a total of KRW 1.5 trillion in hybrid securities (“Early Repayment of Bank Recapitalization Fund”). The outstanding amount to be recovered was thus lowered to KRW 1.2 trillion, or 29% of the Fund’s total utilization.

There does not appear to be information on the repayment of the remaining KRW 1.2 trillion in hybrid securities.

**Figure 4: Fund Purchases and Repayment of Hybrid Securities**

	Allocated amount	Repaid amount (March 2011)	Amount to be repaid (December 2011)	Remaining Amount
<b>Woori</b>	1,000	300	200	500
<b>Kookmin</b>	1,000	400	600	-
<b>Hana</b>	400	100	300	-
<b>NH</b>	750	-	400	350
<b>Suhyup</b>	100	-	-	100
<b>Kwangju</b>	87	-	-	87
<b>Kyoungnam</b>	116	-	-	116
<b>Total</b>	3,453	800	1,500	1,153

Note: Amounts denominated in KRW, billions

Source: *Financial Services Commission 2011*

<sup>4</sup> Hana (KRW 100 billion, Mar. 2011), Kookmin (KRW 400 billion, Apr.2011), Woori (KRW 300 billion, May 2011)

<sup>5</sup> Kookmin (KRW 0.6 trillion), Hana (KRW 0.3 trillion), Woori (KRW 0.2 trillion), and NH Bank (KRW 1.5 trillion)

## II. Key Design Decisions

- 1. The Fund was announced by the Korean government as one of a series of short-term stabilization measures announced on December 18, 2008, in response to the Global Financial Crisis.**

On December 18, 2008, the Financial Services Commission (FSC) announced a package of short-term stabilization measures to be implemented throughout 2009. Among other interventions intended to boost liquidity within the Korean economy, the FSC plans provided support for the domestic financial markets through the establishment of the Bond Market Stabilization Fund and the Stock Market Stabilization Fund, bolstered the soundness of capital reserves through the Bank Capital Expansion Fund, and increased consumer confidence with a series of amendments to existing debt repayment laws. Furthermore, the FSC laid out plans to oversee the restructuring of distressed companies and tighten supervision of the financial derivatives market.

- 2. The Korean government created the Fund under the authority granted by Article 80, Section 6, of Chapter IV of the Operations of the Bank of Korea.**

Article 80 (“Credits to Profit-Making Enterprises”), Section 6, stipulates:

“In severe deflation of monetary credits where financial institutions collect loaned money and restrain new loans, the Bank of Korea may, notwithstanding the provisions of Article 79, extend credits to profit-making enterprises such as those who are engaged in financial business, not financial institutions with the consent of not less than four members.”

According to a press release by the Korean government, there was some debate as to whether it would be more appropriate to rely on Article 80 or Article 65, the latter of which concerned emergency credit to financial institutions.

- 3. All Korean commercial banks, both regional and national, were eligible for Fund use.**

In designing the program, the Korean government aimed to increase average BIS ratios among Korean banks by 1.5%. However, it was not a requirement for participation that banks’ capital ratios fall below a certain threshold; on the contrary, the Fund allowed the government to inject capital into banks with ratios above the BIS requirement of 9%, which had previously not been legally feasible. It was thus hoped that providing stronger capital bases for commercial banks would encourage increased lending to the real economy.

Banks could voluntarily access the Fund when in need of capital.

- 4. Drawing upon public and private sources of funding, the Korean government committed a total of KRW 20.0 trillion for Fund purchases.**

The proposed funding scheme comprised a KRW 10 trillion loan from the Bank of Korea and KRW 2 trillion from Korea Development Bank. The government intended to raise the final KRW 8 trillion by purchasing banks’ subordinated and hybrid securities through the Fund and selling them to institutional investors in the form of securitized bonds.

- 5. Preferred shares, hybrid securities, and subordinated debt were eligible for issuance by participating banks on a capital call basis.**

After having received approval from the FSC, banks could then access the fund on a capital call basis when in need of liquidity.

- 6. Caps on individual banks' participation were imposed according to each bank's asset holdings.**
- 7. A bank's access to the Fund would be contingent upon how well the bank had provided liquidity support to the real economy, SMEs, and corporate restructuring programs.**

Initial interest rates for participation were dictated by the scoring grid described in the 'Outcomes' section. Upon applying for access to the program, each bank would be required to sign with the Korean government an MoU stating its continued commitment to assisting the real economy. The FSC would then conduct monthly progress review and adjust accordingly terms of Fund utilization, interest rates, and other usage restrictions.

- 8. There was no set end date for the Fund's operation.**

### **III. Evaluation**

The Korean government viewed the implementation of the early repayment scheme as an indication that "banks [had] successfully recovered from the 2008 global financial crisis" ("Early Repayment of Bank Recapitalization Fund"). Lee and Rhee have also characterized the Fund as a general success, providing "a safeguard to banks against possible substantial losses" without imposing any "fiscal burden" (2012).

However, a report published in July 2009 by the National Assembly Budget Office noted that the government may not have done enough to destigmatize use of the program; most banks had already raised their Tier 1 capital ratios in 2008, and those that had not were likely to face scrutiny for contributing to the Fund. Furthermore, concerns about government interference in bank management caused larger institutions such as Citigroup and SC Cheil Bank to decline participation. A press release published by the FSC in February of 2009 assured that the government would not intervene in the banks' normal operations.

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