Bank Nationalization, Restructuring and Reprivatization: The Case of Korea since the Asian Financial Crisis

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This article is a case study of the political economy of bank restructuring, privatization and market liberalization in the South Korean banking sector since the 1997/1998 financial crisis. We show that the most crucial factor in that post-crisis bank restructuring was the quick and massive state intervention that involved nationalization or closure of failed banks and a "clean-up" of banks' bad assets through an injection of a huge amount of public funds. This strategy was feasible because the government successfully managed to suppress the vested interests of domestic market participants,

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including shareholders, employees, and borrowers. We argue that the process of bank restructuring and (re-) privatization in Korea cannot be explained just by market dynamics. On the contrary, we stress that a political economic approach offers a more consistent explanation of the government's rush to sell nationalized banks to foreign investors and international banks. Foreign ownership of domestic banks was a politically motivated agenda of the government designed to create an independent and profit-oriented banking sector that could curb the seemingly omnipotent power of the *chaebol* conglomerates within the Korean economy.

Key Words: Korea, Bank Privatization, Banking Reform, Financial Liberalization, Financial Crisis

I. Introduction

Since the 1980s, a growing number of developing and newly industrialized countries have embraced financial liberalization and opened their banking sector to foreign investors, often in response to devastating financial crises. Reflecting this trend, a number of studies examining the impacts of bank privatization and foreign entry on bank performance and developing countries' economies have emerged (Clarke and Cull, 1998; Boehmer et al., 2005; Clarke and Cull, 2005; Clarke et al., 2005; Mihaljek, 2006). Most of these studies have focused on Eastern Europe and Latin America, there having been relatively few studies of East Asian cases.[1] This paucity of East Asian cases is due to the fact that banking liberalization and foreign ownership there have been issues only since the Asian financial crisis of 1997/1998. Before that, the legacy of the developmental state kept foreign bank ownership at lower levels than in other developing regions.

1. There are uncountable studies on financial market liberalization in East Asia, but they concentrate on capital account or equity market liberalization. They do not specifically address the banking sector or foreign equity participation in banking.

This paper discusses the banking sector transformation in Korea in the aftermath of the 1997/1998 crisis under the Kim Dae-jung administration (1998-2003) and the Roh Moo-hyun administration (2003-2008). The 1997/1998 financial crisis demonstrated the Korean banking system's deep-rooted structural malaise inherited from the high-debt model of development. The post-crisis development in the Korean banking sector exhibits trends, including consolidation, privatization and increasing foreign ownership, commonly observed in other crisis-affected developing economies. We analyze the Korean government's approach to Korean bank restructuring, which included comprehensive bailout programs coupled with bold steps to implement far-reaching structural reforms. This was rewarded by manifest success in the form of a remarkably rapid recovery of the banking system.

The case of Korea is an interesting example that allows some general conclusions about the role of the state in resolving banking crises to be drawn. First, we stress the state's role in bank restructuring and privatization. Whereas most scholars agree that governments have to intervene in the event of a banking crisis, most economists perceive this intervention as a short-term stabilization effort, believing that governments should refrain from intervening in the management of banks and allow market forces to take over once stabilization is achieved. In contrast to this market-driven restructuring, we found that in the Korean case, the restructuring was primarily state-led, and not just during the initial phase. In fact, the Korean government used the whole range of state power to push through the restructuring process. Those powers included direct control over banks through nationalization, the use of taxpayers' money for bad-asset disposal and banking recapitalization, and the use of coercive powers to push aside opponents of the restructuring. Markets and particularly financial markets are not spontaneous products but have to be facilitated or even created by the state. In the case of bank privatization in Korea, the government did not just open the gate for private investors but literally had to carry them to the market in a golden sedan. A huge amount of public funds totaling 30 percent of the Korean GDP, coupled with government guarantees, were necessary to refinance the banks and make them attractive to initially reluctant private investors.

Second, we show that privatization is not a process led by pure economic logic and efficiency. Rather, banking privatization in Korea was a highly political process embedded in a larger concept of domestic reform. The government clearly took the side of foreign investors in order to check the power of domestic conglomerates. By reshaping the banking industry to operate as an independent profit-oriented business sector, the former close ties between banks and business conglomerates were loosened. In opening up the Korean markets to foreign investors, the Korean government was not acting simply as an agent of the "Wall Street-Treasury-IMF complex" (Veneroso and Wade, 1998) but it followed a domestic political agenda.

Third, in comparing the performances of state owned, private domestic and private foreign banks, we find that the differences are minimal. All banks regardless of ownership type reduced policy loans while seeking commercial profit but remained trapped in herd behavior. All banks switched from an overexposure to corporate borrowers before the crisis to an overexposure to seemingly safe household loans that led both to the credit card crisis of 2002/2003 and the mortgage boom thereafter. We thus cannot support "ownership-concentrated" studies that suggest a clear causal links between ownership structure and bank behavior. Our data does not support the conventional wisdom among mainstream economists that private banking ownership is superior to state ownership (Megginson, 2005). Contrarily, we find that state-owned banks in Korea perform slightly better than privately owned ones. State-owned banks tend to provide more corporate loans, particularly to SMEs that account for the majority of employment and thus are crucial to the health of the economy. Even though the overall differences between private foreign and domestically owned banks are small, foreign-owned banks seem to be even more risk averse and more biased against corporate lending.

This paper is organized as follows. Section 1 deals with the state-led bank restructuring after the 1997/1998 financial crisis. Section 2 analyses the performance and lending behavior of different types of ownership, including private-, foreign-, and state-owned banks. Section 3 stresses the underlying broad political reform agenda in the bank restructuring process. Section 4 presents conclusions.

II. State-led Bank Restructuring in the Aftermath of the 1997/1998 Crisis

The post-crisis bank restructuring in Korea can be divided in three distinct phases. The first phase between 1998 and 2000 was dominated by the government efforts to avert the systemic failure of the banking sector through nationalization and the injection of massive public funds. The second phase, after basic banking stability was restored in 2001, can be characterized by strategic mergers, privatization and the entry of foreign private equity funds. In the third phase private equity funds sold the Korean banks to foreign multinational banks.

In early December 1997 when the IMF announced its US$ 57 billion bailout package for South Korea, the Korean banking sector was on the verge of collapse. Of the 27 commercial banks at year-end 1997, 12 had capital ratios below 8 percent and two were technically insolvent. The essential components of the government intervention were bold and swift restructuring of failed banks, recapitalization, and clean up of bad assets of viable banks. Applying the global regulatory measure of the Basel capital adequacy ratio, non-viable banks were identified and forced to exit. In the midst of the crisis in 1998, five smaller commercial banks were closed, and two larger, systemically important ones were nationalized. Several non-viable banks, meanwhile, were merged with stronger ones. Viable banks were required to file detailed restructuring plans entailing recapitalization, management improvement, and downsizing (Kim et al., 2006).

The government's initial efforts to restore banking stability were only partially successful. In 2000, banks originally deemed viable failed in their restructuring, due largely to continued large-scale corporate failures. In late 2000, the government declared six more banks technically insolvent. Departing from its initial approach at the height of the crisis in 1998, the government shunned liquidation of insolvent smaller banks and instead opted to keep them all alive to continue their lending operations. This policy change led to further bank nationalization during 2000, because the government believed it could not afford the shock of another banking failure amid the impressive but still fragile macro-economic recovery since 1999. As a result of this second round of nationalization, the number of commercial banks under government control increased to eight, and state ownership in the entire banking sector, including specialized banks, increased from 33 percent in 1996 to 54 percent in 2000 (IMF, 2002: 102).

Nationalization greatly facilitated bank restructuring as the government could injected massive amounts of money into the banking system in order to recapitalize banks and purchase bad loans. This restructuring process successfully stabilized the banking system (see section 2) but came at a high cost for the Korean taxpayer. By mid-2006, the total fiscal support amounted to 168.5 trillion Korean won (KRW). This is equivalent to 30 percent of Korea GDP in 2000 and would be even higher if the welfare costs for laid off workers were included. This makes the Korean financial crisis one of the most expensive in recent history (*Ibid.*, 2003: 14).

Public funds were raised through the issue of government-guaranteed bonds or were taken out of the regular government budget. Three government agencies were established as institutional vehicles for taxpayer-financed restructuring: the Korea Asset Management Corporation (KAMCO), the Korea Deposit Insurance Corporation (KDIC), and the Financial Supervisory Commission (FSC). The FSC in concert with the Ministry of Finance conducted the restructuring process by means of the full range of options, which included forced liquidation, mergers, and nationalization. The KDIC was responsible for bank recapitalization, loss compensation, and deposit protection. KAMCO assumed the roles of bad-bank buy-up and bad-asset disposal, which marked the first-ever opening of a market for distressed assets (He, 2004).

In 2000, the government advanced to a second round of bank restructuring, consisting of strategic mergers and the re-privatization of nationalized banks. Thanks to the decisive government intervention, the banking system had been freed from the shackles of bad loans and was on the road to recovery. Accordingly, the policy objective was shifted to the enhancement of the economies of scale and scope in the Korean banking industry. The Korean banking sector was considered to be "overbanked", which was good for bank customers because there was an abundance of bank branches but was bad for international competitiveness and profits. Reflecting the global trend, Korea was deemed to be in need of bank mergers and "mega banks doing universal banking" (*The New York Times*, December 18, 2002). The government thus took the lead in forming a new landscape in the Korean banking sector. Along with enacting a new Financial Holding Company Act in October 2000, the government merged four nationalized banks (Hanvit, Peace, Kwangju, and Kyongnam) and several non-banking financial institutions to create the Woori Financial Holding Company in April 2001, Korea's first financial holding company providing universal banking services. In October 2001, the government approved the merger of Kookmin Bank and Housing Bank, which formed the largest commercial bank boasting a roughly 30 percent market share in assets. This move put the remaining private commercial banks under competitive pressure to increase their size and market share.

At the same time, the government aimed at re-privatizing nationalized banks, which proved to be much more difficult than expected. Over the course of the bailout, eight insolvent commercial banks (five nationwide and three regional banks) were nationalized. Government ownership of commercial banks was an emergency measure and regarded as temporary and short-term by the economically liberal minded government. Not only was increased government bank ownership detrimental to the goal of banking reform (to end crony capitalism), but mounting public criticism of bailing out banks at taxpayers' expense added pressure for quick action. The first problem that emerged was that there were no domestic investors able to buy Korean banks except for the large business conglomerates known as *chaebol*. However, they were automatically excluded from bank ownership by

Table 1. Total Assets and Ownership Structure of Seven Nationwide Commercial Banks

	Total Assets+	Foreign Share++	
Kookmin Bank	198.2	85.7%	Merger with Housing Bank in 2001, incorporated into a financial holding in 2008 Major shareholder: Bank of New York (15.21%)
Shinhan Bank	181.5	57.1%	Incorporated into a financial holding in 2001 Acquisition of Chohung Bank in 2003 Major shareholder: BNP Paribas (8.83%) KDIC (5.31%)
Woori Bank	152.7	11.7%	Created by merger of Hanil bank and Korea Commerce Bank in 1999, renamed Woori in 2002 Incorporated with two regional banks into Woori Financial Holdings in 2001 State-owned with 77.97% stake. Privatization postponed
Hana Bank	106.7	76.6%	Acquisition of Seoul Bank in 2002 Incorporated into Hana Financial Holdings in 2005 Major shareholders: Goldman Sachs (9.34%), Themasek (9.06%) Templeton (8.13%)
Korea Exchange Bank	66.8	74.2%	Owned by Lone Star, 64.62%. Resale to HSBC announced in 2008, but failed
SC First Bank	57.2	100%	Former Korea First Bank
Citibank Korea	51.3	100%	Former KorAm Bank

*Source: FSS & data compiled by authors with data from the Korea Stock Exchange database ([http://sm.krx.co.kr/webkor/market/market_index.jsp]).
** Note: +As of September 2006, in trillion KRW; ++As of end 2005.

the Korean Banking Act, which prohibited non-financial corporations from owning more than 4 percent of the voting shares of commercial banks. Given that the *chaebol*'s over-borrowing was considered to be the main culprit behind the 1997/1998 crisis, relaxing such restrictions was politically undesirable.[2]

2. In 2002, the ceiling on the ownership of a single entity in a bank was raised to 10% to facilitate sales of government-held stocks. However, in the case of non-financial institutions, investors are allowed to exercise no more than 4 percent of voting rights.

Foreign ownership of banks seemed to be a feasible alternative. Financial crises are often a catalyst for foreign entry into local banking sectors. The IMF and most economists argue that financial market liberalization and foreign bank ownership can help to resolve financial and banking crises by providing new funds from abroad (IMF, 2006). Financial market liberalization is therefore one of the core elements of the IMF's structural adjustment programs. After the 1997 crisis, the Korean government moved quickly with financial opening — indeed faster than the IMF had requested. In May 1998, the government abolished the remaining barriers to foreign entry into the domestic financial markets, even allowing hostile takeovers. At the same time, financial liberalization was accelerated and including dealings in foreign exchange (Yang, 2003: 71-89), the establishment of investment funds, the purchase of public and corporate bonds by foreigners, access for foreign insurance companies, and many other reforms. This made the Korean financial market one of the most open markets to foreign investors — at least concerning the formal regulations.

In retrospect, the increase of foreign presence in the Korean banking sector is impressive. The market share of foreign-owned banks including foreign bank branches, measured in assets, increased from 8.1 percent in 1997 to 31.1 percent at the end of 2005. Foreign equity ownership in domestic-controlled private commercial banks showed an even more dramatic surge (See Table 1). Except for one state-owned bank, in all six private-owned nationwide commercial banks, the aggregate equity shares held by foreigners exceeds 50 percent. Two of them are now wholly foreign-owned subsidiaries. The average ratio of foreign equity shares in the Korean banking sector accounted for 66 percent as of end-2005, the sixth highest in the world. This was a dramatic change compared with the closed banking market before the 1997 crisis, but the figure nonetheless is lower than in many other crisis-affected countries in Latin America or Eastern Europe.

However, foreign entry was not as straightforward as the numbers suggest. For example, the number of foreign bank branches in Korea has actually declined since 1997s (FSC, 2007b). More importantly, during the crisis, foreign investors, in particular foreign banks, avoided the Korean banking sector because it appeared to be too risky and banks were reluctant to get involved in the messy restructuring of banks themselves (*International Herald Tribune*, December 17, 1997). The Korean banking system was still remained fragile, because corporate borrowers continued to stumble. In addition, poor transparency and opaque accounting practices that masked the true size of problem loans exacerbated potential risks. Foreign participation began to increase substantially only at the end of 1999, when the overall economic conditions showed clear signs of recovery from the crisis and the government already stabilized the banks through the injection of public funds. Foreign investments in minority equity shares of local banks surged. Even then, foreign banks still shunned Korea. Rather, buyout funds took the lead, and bought controlling stakes in three nationwide commercial banks.

When two banks — Korea First Bank (KFB) and Seoul Bank — were offered for sale in mid-1998, less than six months after nationalization, there were only two bidders, HSBC and a Consortium led by Newbridge Capital, a U.S. private equity fund. Both showed interest in KFB, but neither wanted to buy Seoul Bank. The KFB sale negotiation with HSBC, favoured by the Korean government, failed, because HSBC wanted a much larger stake, as large as 80 percent, whereas the government wanted to hang on to more of its own stake. Seeking at least US$ 2 billion for a portion of its 93.8 percent stake in KFB, the government hoped that if a buyer succeeded in turning KFB around, its shares would be worth more, which would help it to recover a larger portion of the 1.5 trillion KRW (US$ 1.25 billion) in tax money that it had used to re-capitalize the bank (*The New York Times*, January 1, 1999; KOTRA, 1999). The subsequent negotiations with HSBC for Seoul Bank collapsed due to unbridgeable differences in the valuation and classifications of Seoul Bank's loan portfolio. After the negotiations with HSBC failed, the government hastened in December 1999 to complete the deal with Newbridge Consortium, which agreed to buy only a 51 percent stake in KFB (Kang, 2003: 6). This was the first takeover of a major Korean commercial bank by a foreign investor.

Further foreign takeovers followed. In early 2001 Carlyle Group, another U.S.-based private equity fund, acquired a 40.7 percent controlling stake in KorAm bank, the seventh largest commercial bank. In 2003, Lone Star, a third U.S.-based private equity fund, took over a 51 percent controlling stake in Korea Exchange Bank (KEB), the fifth largest lender.

The sale of major commercial banks to foreign investors earned international accolades, but sparked a heated political debate in Korea. In the case of KFB, after having injected more than 8 trillion KRW to rescue and re-capitalize the bank, the government agreed with Newbridge to sell a 51 percent controlling stake for only 500 billion KRW (US$ 417 million). The government also agreed to "put back options" in the sale contract that provided a guarantee for three years after the transaction to cover liabilities originating from the bank's old loan portfolio (*Asiaweek*, January 15, 1999). Thus, the government had to continue to inject public funds into KFB, to the tune of around 18 trillion KRW, an amount equivalent to 36 times the price Newbridge Capital had paid for the takeover of the bank (*Financial News*, November 15, 2004). The deal between the government and Newbridge provoked a public outcry over "fire sale" privatization. Another problem was that the government supported the takeover of major domestic banks by foreign buyout-funds, saying that concentrated ownership in the hands of foreign investors would boost the banks' own incentive to restructure and help thus to strengthen their efficiency.

The government's policy also collided with the Korean bank core-ownership regulations introduced in early 1980, which clearly limit the voting share of a non-financial company to 4 percent, and which implicitly calls for, thereby, a dispersed bank ownership structure. The private equity funds' takeovers were hardly in line with the current banking ownership regulation, in that under the Korean Bank Act, they are classified as non-financial institutions and therefore subject to the 4 percent voting share limit. Inevitably, a political controversy emerged. Pointing out the preferential treatment of foreign investors and concomitant legal discrimination against domestic non-financial institutions, critics mainly from the opposition party and conservative press attacked the government's approval of the foreign takeovers. Some *chaebol* joined conservative critics of such "reverse discrimination" against domestic firms, demanding equal treatment. This conservative critique found a strong appeal in the public and was supported by the nationalist wing of the Korean left. The debate shifted from how to attract more foreign capital to the banking sector to how to limit foreign influence (Lee, 2002). Consequently, foreign takeovers became politically more difficult and the government concentrated on pursuing domestic mergers. In December 2002, Seoul Bank (government share 100 percent) was sold to Hana Bank and in September 2003, Chohung Bank (80 percent) and Cheju-bank (95.7 percent) were sold to Shinhan Bank.

Only after the government-led bank refinancing and restructuring eliminated the potential risks of bank failure, and after private equity funds explored the Korean market, did foreign multinational banks finally show interest in the Korean banking sector. Suddenly, fierce bank takeover battles erupted among foreign rivals as well as between foreign and domestic bidders aggressively vying for larger market shares. In April 2004, Citigroup beat out SCB and HSBC to buy KorAm Bank from the Carlyle Consortium, which had held a 40.7 percent controlling stake since early 2000 (*Financial Times*, March 3, 2004; Business Week, April 24, 2004). Newbridge sold its 51 percent stake of KFB in December 1999 to SCB, which won out over HSBC, in early 2005 (*The Independent*, January 10, 2005; *International Herald Tribune*, January 11, 2005). Both foreign banks secured 100 percent control, acquiring the remaining stake through subsequent tender offers. In the latest case Lone Star, which took over the fifth largest lender, Korea Exchange Bank (KEB), in September 2003, moved to dispose its 51 percent controlling stake in March 2006. Two domestic-controlled banks — Kookmin and Hana — made joined bids with Citigroup and Goldman Sachs respectively. Kookmin, the largest lender in Korea, was appointed as the preferred bidder, but the deal was cancelled in January 2007 in the wake of ongoing criminal investigations into alleged irregularities involving Lone Star's initial acquisition of KEB in 2003.[3] HSBC, after having repeatedly missed opportunities to take over Korean Banks, vied for the KEB deal but the Korean government, still owning a 12.37 percent stake in KEB, remains indecisive due to the ongoing Lone Star probe. Although further privatization plans for two state-owned special banks, Korea Development Bank (KDB) and Korea Industrial Bank (KIB) were announced in mid-2007, it appears unlikely that the Korean government will overcome the political inertia against foreign takeover of Korean banks.

III. Bank Ownership and Performance

As a result of bank restructuring, the landscape of the banking sector dramatically changed. The government reduced the number of commercial banks from 27 (late 1997) to 13 (2007): seven nation-wide and six regional banks. Of the 13 commercial banks, the four largest and three regional banks are now under the umbrella of financial holding companies. Three other regional banks remain independent and three medium-sized nation-wide commercial banks were sold to foreign investors that passed them on to foreign banks. The restructuring led to a massive concentration in the banking sector as the asset share of the three largest banks has more than doubled from 27 percent in 1997 to 63 percent in 2005. Bank employees had to pay a high price as the number of employees in the banking sector was massively reduced from 114,000 in 1997 to 68,000 in 2001, a reduction of 40 percent within four years.[4] At the same time, stability and profitability of the Korean banking industry dramatically increased. In 1997, only 12 out of 26 commercial banks in Korea met the Bank for International Settlements (BIS) capital adequacy ratio of 8 percent, the average BIS

3. Korean prosecutors investigating whether Lone Star manipulated the capital adequacy ratio of KEB, enabling it to pay a discounted price when it acquired the bank, declared the deal illegal.
4. Since then, the reduction has been slowed. As of end-2005, the total number of staff in commercial banks stood at 66,890 (FSS, FISIS, [http://efisis.fss.or.kr/index.html])

ratio being 6.2 percent (Emery, 2001; IMF, 2005: 36). In 2005, the average BIS ratio reached 12.5 percent. Substandard loans fell from 7.2 percent in 1998 to 1.3 percent in 2005. Net profits witnessed a dramatic surge to 10.1 trillion KRW in 2005 from a loss of 10.1 trillion KRW in 1998. Return on Equity (ROE) and Return on Assets (ROA) increased from -48.63 percent and -2.99 percent to 20.52 percent and 1.25 percent respectively during the same period (Table 2). In 2005, *Business Week* (November 7, 2005) stated that the successful bank restructuring since 1998 has made Korea "a great place to be a bank." However, what was the role of foreign bank entry in improving bank performance? The impact of foreign investors on the efficiency and stability of the banking systems of developing and newly industrialized countries has been the focus of the scholarly literature on bank privatization so far (Megginson, 2005). Most scholars conclude that foreign bank entry into local markets had positive effects on both banking sectors and the overall economies, but the issue remains controversial (IMF, 2000; Bayaktar and Wang, 2004).

Table 2. Profitability of Nationwide Commercial Banks (Trillion KRW)

	1998	1999	2000	2001	2002	2003	2004	2005
Net Profits before Tax	-10.1	-1.3	-1.8	3.6	3.7	0.25	6.0	10.1
Return on Equity (%)	-48.63	-24.3	-10.81	16.30	10.95	0.87	18.23	20.52
Return on Assets (%)	-2.99	-1.42	-0.53	0.79	0.56	0.04	0.89	2.25
Substandard Loans (%)†	7.2	13.8	8.8	3.3	2.4	2.8	2	1.3
BIS Capital Adequacy	8.22	10.79	10.52	10.81	10.46	10.34	11.31	12.51

* Source: FSS.

** Note: † Includes loans classified as substandard, doubtful and estimated loss.

Many studies stressing the potential benefits of foreign entry into developing economies argue that foreign-owned banks perform better than their domestic counterparts and that private ownership of banks is generally preferable to state ownership (Clarke et al., 2005; Megginson, 2005). In the Korean case there is no strong evidence supporting this hypothesis at least until now. On the contrary, a comparison of the key financial indicators revealed that foreign-controlled banks (KEB, KorAm and KFB) tended to have lower profitability than their domestic counterparts (See Table 3). The average return on assets (ROA) and return on equity (ROE) of the three foreign-controlled banks between 2001 and 2005 accounted for 0.59 percent and 11.29 percent respectively, lower than those of the four domestic banks at 0.89 percent and 17.37 percent. Notably, state-owned Woori outperformed private-owned and foreign-controlled banks and showed on average the highest level of ROA and ROE. The BIS capital adequacy ratio, the bad loan ratio and the productivity measured by total assets per employee exhibited no significant differences according to ownership type.

Table 3. Key Financial Indicators of Seven Nationwide Commercial Banks (Average 2001-2005)

	BIS Ratio	**ROA**	**ROE**	**Substandard Loan Ratio**	**Loan Growth**
Woori	11.59	1.32	23.85	2.01	16.6
Kookmin	10.91	0.52	8.51	2.88	5.3
Shinhan	11.51	0.75	17.26	1.69	12.1
Hana	11.36	0.97	19.89	1.54	4.9
KEB†	10.55	0.84	14.81	2.35	7.1
CitibankKorea††	12.25	0.61	12.84	1.64	7.5
SC First†††	11.89	0.32	6.22	3.46	22.3

* Source: Authors' own calculations based on data from FSS, Banking Statistics.
** Note: † Lone Star holding controlling stake since September 2003.
†† Former KorAm bank, Carlyle November 2000, Citigroup April 2004.
††† Former Korea First Bank, Newbridge December 1999, SCB January 2005.

Bank performance should not just be measured in terms of profitability and stability but also concerning the ability of banks to act as effective intermediary institutions providing loans for investors and consumers. The average loan growth rate varies widely from bank to bank, but there is no clear correlation between loan growth and ownership. Foreign-controlled SC First Bank showed on average the highest loan growth rate, 22.3 percent, followed by state-owned Woori, 16.6 percent, and Shinhan (domestic private-controlled), 12.1 percent. Other banks exhibited a modest credit expansion. On the other end of the spectrum, Hana and Kookmin (domestic private-controlled) as well as KEB and Citibank (foreign controlled) show lower loan growth. After Citigroup's takeover of KorAm, the bank witnessed a sharp decline in total lending of 13.5 percent, from 30.1 trillion KRW in 2004 to 26.6 trillion KRW in 2005. As of September 2006, the total lending of KorAm stood at 28.2 trillion KRW, a slight increase in comparison to the end of 2005, but still below the level of 2004. In general, credit expansion has slowed, reflecting the lower economic growth rates since 2001.

Some differences in lending behavior by ownership type can be observed. Whereas all banks have shifted lending from corporations to households, foreign-controlled banks have expanded household lending more aggressively and are even more reluctant to lend to small and medium sized enterprises (SMEs). Between 2000 and 2005, the average growth rate of the household loans of the three foreign-controlled banks stood at 29.4 percent, in comparison with the 17.3 percent of the four domestic-controlled banks. Foreign-controlled banks tend to have higher household lending shares than domestic-controlled banks. Lending to households in foreign-controlled banks accounted for 56.6 percent of total lending in 2004, up from 32.8 percent in 2000. The same ratio in domestic-controlled banks rose only from 27.1 percent to 39.4 percent. Foreign-controlled banks were more reluctant to lend to SMEs, and exhibited a larger decline in the share of lending to SMEs than their domestic counterparts (see Table 4). As of December 2006, the combined share of the three foreign-controlled banks and the foreign bank branches in total loans to SMEs was only 9.6 percent, in comparison with the 13.5 percent of state-owned Woori and the 31.4 percent of the domestic-controlled private banks.[5]

The outcome of the changed lending structure is ambivalent. Over-lending to *chaebol*, which caused the crisis of 1997/1998, was reduced but it seems that it was replaced by over-lending to house-

5. The share of all seven nationwide commercial banks in total SME loans accounted for 53.9% at the end of 2006. State-controlled specialized banks played a crucial role in providing credit to SMEs, representing 35.7% of the total loans to SMEs FSS (2007).

Table 4. Lending Practice Comparison between Foreign and Domestic Banks 2000-2006 (%)

		2001	2002	2003	2004	2005	2006
Corporate Loans/Total	Domestic	45.5	44.5	44.2	43.2	40.9	40.5
	Foreign	53.7	51.4	48.7	45.0	40.1	38.9
Of which SME	Domestic	35.9	37.1	40.1	38.7	36.4	36.8
	Foreign	32.2	36.9	37.4	34.5	31.6	33.2
Household Loans/Total	Domestic	38.6	54.2	54.8	55.7	57.9	58.1
	Foreign	40.6	46.1	49.4	53.3	58.2	59.9

* Source: FSC (2007a).

holds. The sharp decline in the ratio of corporate loans to total loans reflects the corporate debt reduction efforts and tougher corporate lending regulations that took place in the course of the post-crisis bank restructuring, which affected all types of banks. Unfortunately, the new risk assessments introduced by banks have neither changed the herd mentality nor prevented risk miscalculations. Unchanged behavior with regard to reckless lending and poor risk management in the Korean banking sector, regardless of ownership type, can be best illustrated by the credit card crisis of 2003. Overextension of consumer lending in 2001/2002 helped banks to generate profits but created a credit card bubble. The following bust posted a combined deficit of US$ 9 billion for major credit card firms and more than 4 million Koreans — or nearly ten per cent of the entire population — defaulted on their credit card payments. In subsequent efforts to resolve the credit card crisis, the government again intervened, bailing out the largest credit card company, LG-Card, with a US$ 4.5 billion rescue package spearheaded by the state-run Korea Development Bank (KDB).

Interestingly, once the credit card crisis broke out, foreign and domestic-owned banks showed very different behavior. Whereas most creditors to LG-Card agreed to cooperate in the bailout plan, the two foreign-controlled banks, KEB and KorAm Bank, retreated from the initial agreement. KEB, the third largest lender to LG-Card, withdrew its commitment, KorAm Bank agreeing to supply new loans but declining to participate in a debt-for-equity swap (*Financial Times*, February 6, 2004; *The Korea Times*, February 6, 2004). Although both foreign and domestic banks lent recklessly to LG-Card, they differed in their willingness to cooperate with the government in bailing out the bankrupt credit card companies. Ironically, the government's plan to establish banks as an independent business with the help of foreign investors undermined the government's own rescue strategy. Whether this is a positive or a negative development is controversial. The foreign-controlled banks' refusal to help in the financing bailout might reduce moral hazard and reckless lending in the future, but their reluctance to participate in bailouts also impedes the ability of the government to stabilize the financial markets in the way it successfully did after 1997/1998.

After the credit card bubble burst, the banks' herd lending turned to the mortgage markets fuelling speculative investment in real estate and feeding a housing bubble. Housing prices increased an average of 35.9 percent from 2003 to 2006. Home prices in certain speculative areas rose 70 percent in the same period. Household debt as a share of GDP increased to 66.9 percent as of the third quarter of 2006, from 51.8 percent in 2001. The financial authorities in 2006 imposed a series of measures to curb excessive mortgage lending, but household loans continued to increase (*The Korea Times*, January 11, 2007). The collapse of the housing price bubble is most likely the next crisis waiting to happen, particularly if we consider the bursting of real estate bubbles in the U.S.A. and parts of Europe since mid 2007.

IV. Political Economy of Bank Restructuring and Privatization

Government ownership of banks and proactive government interventions have been the major forces behind the radical restructuring of the Korean banking sector. Although reprivatization has advanced at a slow pace and the government still has not fully relinquished its shareholdings in the commercial banking sector, this has not affected bank performance in a negative way as we have seen above. This fact contradicts the government's official argument that foreign ownership strengthens bank efficiency and performance. If foreign-owned banks are not performing better than state-owned banks, why was the Korean government so eager to privatize banks and why did the government support foreign entry into the Korean banking sector? As it has often been the case, Korean bank nationalization, restructuring and reprivatization have been driven by a political economic logic rather than pure economic rationality. The post-crisis banking reforms in Korea like the financial restructuring in general, can only be understood if they are seen as embedded in a broader political and economic reform agenda (Kalinowski and Cho, 2009).

The governmental change in 1998 is of striking importance to any understanding of the post-crisis economic transformation in Korea. For the first time a president was elected from the opposition, which reflected a fundamental change in the socio-economic and political constellation. The election of President Kim Dae-jung (1998-2003) was not only a milestone for the Korean democratization process that begun in 1987, but anticipated the possibility of radical economic reform. Compared with their predecessors, President Kim Dae-jung and his successor Roh Moo-hyun (2003-2008) were less entrenched in the patronage system comprising *chaebol*, finance and the state. On the contrary, their support came from social and political groups like in the tradition of the democratization movement, labor unions and NGOs that had long been opponents of the crony capitalist establishment. A decisive approach to bank restructuring in Korea was possible because the new governments came from the anti-establishment opposition and were politically committed to profound reforms even to the extent of suppressing opposition. Instead of leaving restructuring to the market, the government was willing to take the initiative and use the whole spectrum of the state's powers of intervention in order to push the reforms through. Bank nationalization and the massive bailout provided the government with the critical political leverage necessary to implement a comprehensive overhaul of the banking industry and use state control over the financial sector to implement a much broader reform agenda of market-oriented reforms in the corporate sector.

Until the 1997/1998 crisis, banks had always had a weak position within the Korean political economy. Their role as an independent business sector was constantly challenged, on the one side by a government that utilized banks to finance their development goals and on the other by powerful business conglomerates (*chaebol*) that used the banks as cash cows. The banks' further weakened position during the crisis made nationalization relatively easy. Most importantly, there was virtually no resistance from bank shareholders even though the government wiped out the entire shareholder capital of failed banks before their nationalization. Bank shareholdings in Korea were widely dispersed before the crisis and there were, thus, no large shareholders that had the power to lobby the government. In addition, due to minority shareholders' lack of legal protection, they could not adequately defend their interests. Neither was there any considerable resistance from big business (*chaebol*) to post-crisis banking reform. Rather, they supported the government's commitment to the privatization of banks and believed that this ultimately would allow them to expand into the commercial banking sector.

The only severe opposition to bank restructuring came from the banks' labor unions. The government's vigorous restructuring push caused some of the largest and most intense protests by labor unions since 1997.[6] The government, however, was determined to force the reforms through by means of the whole spectrum of state power. To co-opt labor unions, the government legalized the Korean Confederation of Trade Unions (KCTU), an umbrella organization of independent labor unions. The government promised to improve workers'

6. In December 2000, more than 12,000 bank employees of Kookmin and Housing Bank went on strike for one week, rejecting the merger of two banks and layoffs in connection with the merger and restructuring (*Financial Times*, December 28, 2000). In July 2003, employees of Chohung Bank walked out for five days to oppose the privatization and sell off to Shinhan Financial Group (*The New York Times*, June 22, 2003). Also, since Citibank's purchase of KorAm Bank in 2004, labor unions have staged several small strikes in protest.

rights and to extend the social safety net for the unemployed in order to make layoffs easier. Furthermore, it also invited the KCTU to participate in tripartite government-business-labor union talks. In return, the labor unions generally accepted bank restructuring and layoffs. At the same time, the Kim and Roh administrations were willing to push their agenda through against their supposed allies and even used laws stemming from dictatorial times to suppress labor strikes and protests. Consequently, many of the strikes by labor unions against bank restructuring and layoffs were declared illegal and crushed by police. The government claimed that these authoritarian measures were necessary in order to "restore investor confidence in Korea's faltering economic reforms" (*Financial Times*, December 28, 2000).

The Kim and Roh administrations strongly believed that at the root of the devastating economic crisis of 1997/1998 was the crony capitalist linkages among *chaebol*, finance and the state, and vowed to remedy structural defects inherited from the past development model. The new political leadership under President Kim Dae-jung called for a transformation of Korea from a *chaebol*-dominated economy to a "democratic market economy" (Kim, 1996). This was in line with President Kim's long-held credo that crony capitalism and *chaebol* dominance were major obstacles to democracy and sustainable economic development. In his decades-long struggle for democracy as an oppositional politician, he often highlighted state control over finance as a crucial tool of the military dictatorship (Woo-Cummings, 2001: 364-365). However, whereas Kim criticized state control over the economy, he was fully aware that a simple withdrawal of the government would only strengthen the monopolistic power of the *chaebol*. Therefore, the guiding principal was to create a functional market through decentralization of economic power, which itself was to be achieved by weakening the *chaebol* and bringing in new powerful actors. In this context, the IMF intervention on behalf of free market capitalism and its proposal to open the Korean financial markets to foreign investors had a strong appeal for the government. The external pressure from the IMF provided the government with an excuse to push through painful reforms as well as a scapegoat to which criticism could be diverted.

To achieve its broad reform goals, the government adopted a two-track strategy, fully backed by the IMF. The first part of the strategy was aimed directly at the *chaebol*. In line with the corporate governance reforms proposed by the IMF, strict investment regulations were imposed, which involved an obligatory reduction in debt-to-equity ratios to less than 200 percent and cross-affiliate equity investment caps. The *chaebol* were forced to reduce their debt level as well as debt guarantees and cross-shareholding among affiliates of the same conglomerate. They also were required to follow stricter accounting and transparency rules. Moreover, minority shareholder rights were improved (Kalinowski, 2008) and appointment of outside directors to company boards was made compulsory.

The second part of the strategy indirectly targeted the *chaebol* by using the financial system to check and balance their dominance. The *chaebol*'s aggressive expansion in the 1990s was made possible by nearly unlimited access to funding through close ties with commercial banks as well as their own non-banking financial companies. Consequently, it was seen that the most effective way to curb the *chaebol's* growing power was to liberate the financial sector from their influence.[7] During the financial restructuring, the government did not hesitate to shut down non-bank financial companies mostly owned by the *chaebol*. In order to weaken the linkage between commercial banks and the *chaebol*, the government forced banks to act as truly profit-oriented commercial banks, in accordance with market discipline.[8] The FSC established in April 1998 to conduct bank restructuring using U.S. banks' business strategy and organization as the "best practice" model (Park, 1999). Foreign participation was seen as the most feasible option for building a market-ruled, independent banking sector, because foreign investors are outside of Korean crony capitalism

7. On the structural problems related to the *chaebol*'s dominance in the Korean economy, see Haggard et al. (2003).
8. The Kim Dae-jung government's approach to *chaebol* reform was based on bank-led corporate restructuring. For more details on the bank-led approach to *chaebol* reform, FSC (1998); Haggard et al. (2003).

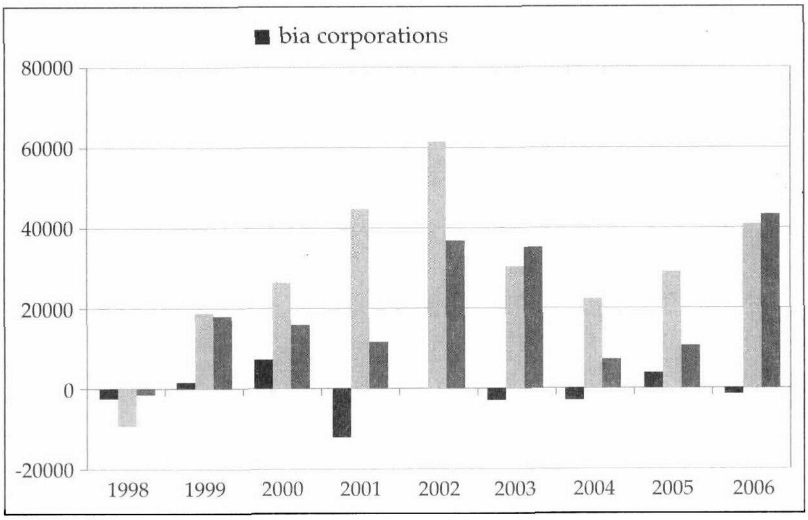
appeared to be the instrument of choice to enforce corporate sector restructuring. Bank managers and board directors appointed by the government had to carry out the FSC's mandates for improving banks' financial conditions and reform management structures.

When the government initially initiated re-privatization in 1998, foreign investors were selected as strategic buyers that would be able to establish the Korean banking sector as a profit-oriented business sector independent from both government and the *chaebol*. Moreover, the political support for foreign ownership of domestic banks was an attempt to preclude a return to dispersed ownership, because without powerful shareholders, the control of bank management would be weak, and banks would then have been in danger of again falling back under the influence of their largest customers — the *chaebol*. This would have re-established the pre-crisis structure, a result that clearly was not wanted. Due to the lack of major domestic investors outside the *chaebol*, the only logical alternative to state ownership was foreign bank ownership.

As we saw in section 2, the strategy to separate domestic financial institutions and the *chaebol* was partially successful. Following the government's reform guideline, commercial banks in both the private and public sectors made determined efforts to reduce their lending exposure to the *chaebol*. Loans to large corporations since 1998 have tended to show a net decrease (see Figure 1). Outstanding loans to large corporations have been declining, accounting for only 4.1 percent of total loans for end-2006. This tendency was reinforced by forced deleveraging of large corporations. The debt-equity ratios of manufacturing firms, which reached a notoriously high level of more than 400 percent in 1997, fell dramatically. As of end-2007, the average debt-equity ratios of 579 listed non-financial firms stood at 81 percent.

Obviously, the link between commercial banks and the *chaebol* has weakened. The Korean banking industry was successfully transformed into an independent business sector and is no longer a tool neither of government's industrial policies nor of the *chaebol*. So far, the government's immediate goal — making commercial banks independent from the *chaebol* — has been achieved. However, the broader

Figure 1. Increment in KRW-denominated Loans of Commercial Banks (10 billion KRW)



* Source: BOK (1998-2007).

political objective underlying the post-crisis reforms — using the banks to balance the dominance of the *chaebol* — has been less successful. In fact, the opposite happened as the *chaebol's* expansionist course is unimpeded and today they command an even greater market dominance than before the crisis. Due to a series of bankruptcies and corporate restructuring, there are now fewer *chaebol*, but those that have survived have become even larger and more powerful. From 1995 to 2005, the market shares of the 50 largest manufacturing corporations rose from 33.6 percent to 38 percent (FTC, 2007: 110). The number of affiliates owned by the 10 largest conglomerates also increased dramatically, from 149 in June 2003 to 459 in June 2008. A mergers and acquisitions wave unleashed during the post-crisis corporate restructuring period provided the surviving *chaebol* with new opportunities to expand. In funding their expansion, they were no longer dependent on financial assistance from banks. Instead, they used cash holdings that had surged after the crisis or utilized capital markets to which they had privileged access. In short, the government efforts to contain the *chaebol*'s power through market discipline proved to be largely ineffective.

With the *chaebol* resurgent, the Kim Dae-jung administration lost its reformist zeal. Not only had rapid economic recovery lessened the formerly urgent need for overhaul of the economic system, the credit card crisis of 2003 was a severe setback for the government. Furthermore, the benefits of foreign bank ownership became not as clear-cut as the government had vigorously asserted them to be. Rather, the dominant foreign presence in the Korean banking sector fostered economic nationalism, which was largely the result of the government's contradictory stance on bank ownership. While the government had no plausible explanation why foreign investors were treated differently from domestic ones, the conservative political opposition demanded a level playing field for domestic investors by allowing the *chaebol* to own banks. This shifted the banking reform battlefront to a monochromatic ownership issue. Taking advantage of the changed political atmosphere, the *chaebol* began to raise their voice again. They have offered themselves as the only capable and reliable domestic power to counterbalance the increased foreign influence in the banking sector. The inauguration of the conservative President Lee Myung-bak in 2008 was a crucial turning point in favor of the *chaebol*. After ten years of two economically and politically liberal presidents, Korea's government is back under the control of the conservative party that ruled until the Asian financial crisis in 1997. As a former CEO of a *chaebol* company, President Lee has promised more *chaebol*-friendly policies. Among these measures is a relaxation of bank ownership by nonfinancial companies.

V. Conclusions

In this paper, we found that bank privatization and foreign ownership in the banking sector in Korea has differed from what most economists and the conventional wisdom about market reforms would expect. First, the Korean government's intervention went far beyond short-term crisis resolution and played a major role in enforcing institutional reforms in the banking sector. The government successfully carried out the intended reforms by using the full range of state power: a) spending huge amounts of taxpayers' money to socialize debts and make banks attractive (i.e. profitable) for foreign investors, b) setting reform guidelines and forcing banks to follow them, c) strengthening the regulations that keep the business conglomerates out of the privatization race and d) using a mix of cooptation and coercion to override resistance from protesting labor unions.

The whole restructuring and privatization process was state-led and private-investor initiative was weak, at least initially. Ironically, the state's dominant role in bank restructuring was the pivotal force behind the successful commercialization of banks that ended their subordination to government and big business. However, the path to an independent and profit-oriented banking system was long and expensive. Nationalized banks could only be successfully privatized after they had been made profitable by the government through massive refinancing, restructuring and downsizing. The case of Korea's bank restructuring is a good example of the logic of socializing losses and privatizing profits as the basis of private economic initiative and market functioning.

Second, we characterized bank privatization as a political process that does not follow a pure logic of "economic efficiency." Instead, privatization was driven mostly by four elements: a) a free market ideology that simply believed in the higher efficiency of private-owned banks, b) domestic political motives to curb the *chaebol's* monopoly power, c) international pressure, particularly from the IMF, and d) protectionist policies that have re-emerged along with the economic recovery, aiming to gear up domestic players in newly opened competitive financial markets.

Third, we illustrated the success of the state-led restructuring as manifested by economic efficiency and profitability. We showed that state owned banks can be as well managed as banks owned by private investors. Indeed, we found that in Korea, state-owned banks actually performed better in many aspects. We also found that the successful establishment of banking as an independent and profit-oriented business sector had its price. Improved efficiency concerning profitability led to reduced efficiency in the functioning of banks as intermediate institutions transferring savings into investments. Lending to the corporate sector and particularly SMEs decreased dramatically. We could not find evidence that privatization reduces moral hazard and unhealthy lending behavior. Regardless of their ownership structure, banks in Korea tend to show herd behavior and overlending to a particular sector. Thereby, bank lending fuelled one financial bubble after the other. Overexposure to *chaebol* lending, up to the crisis of 1997/1998, was replaced by a credit card bubble that went bust in 2003, which was followed in turn by overexposure to mortgages that has since fuelled a housing bubble. The global financial crisis and the bursting of real estate bubbles in the U.S. and many other countries since 2007 make it highly likely that overexposure to mortgages and household debt will mean new trouble for Korean banks.

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