For Official Use **DAF/COMP/WD(2009)15**

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development **03-Feb-2009**

English text only

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WD(2009)15
For Official Use

COMPETITION AND FINANCIAL MARKETS

Roundtable 2 on the Role of Competition Policy in Financial Sector Rescue and Restructuring

-- Note by Korea --

This note is submitted by Korea to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 16 - 18 February 2009.

JT03259132

Document complet disponible sur OLIS dans son format d'origine
Complete document available on OLIS in its original format

English text only

THE ROLE OF COMPETITION POLICY IN FINANCIAL SECTOR RESCUE AND RESTRUCTURING

-- Contribution by Korea --

1. Introduction

1. Korea carried out a full-fledged restructuring in the financial sector as a way to overcome the financial crisis that struck Asia in 1997. But given that its financial restructuring initiative was taken as part of conditions to receive IMF emergency rescue funds, it was inevitable that the Korean government had certain limits in exercising its discretion.

2. This paper will overview the specific characteristics and substance of Korea's financial restructuring carried out in the wake of the Asian financial crisis and then assess its impact on the Korean financial market from a competition policy perspective.

2. Characteristics of Financial Restructuring of Korea[1]

3. In Korea, financial restructuring was carried out in an unprecedentedly swift manner, upon the request of the IMF and with the firm commitment and thorough planning of the Korean government. On December 3rd, 1997, Korea signed an MOU with the IMF for emergency loans and thereafter, over a total six times until July 24th, 1998, Korea sent the Letter of Intent to the IMF. As a result, it took just 7 months for Korea to set up a legal and institutional framework to proceed with financial restructuring and begin to carry out a sweeping clean-up of ailing merchant banking corporations and commercial banks and disposal of their bad assets.

4. Comparing with Thailand and Indonesia, which were infused with IMF emergency funds in sometime around 2007 as well, Korea showed distinctive characteristics in going about financial restructuring.

5. First, Korea is said to have met the following requirements that the IMF reckoned are essential to a successful financial restructuring; a comprehensive approach, prompt action, firm exit policies and designating a lead agency. All things considered, the success of Korea's financial restructuring is attributable to favorable internal and external circumstances.

6. That is, on the external front, the insurmountable pressure was at work that Korea's failure to comply with measures set out in the Letter of Intent would lead to the suspension of IMF loans. On the internal front, there was a public consensus that financial restructuring should be carried out rapidly for Korea to fast escape from the economic crisis.

---

1 (2000), Financial & Corporate Restructuring: Unfinished Reform, Samsung Economic Research Institute

7. Second, Korea was faster in establishing the necessary legal and institutional groundwork for restructuring as it had been pursuing its own financial reform way before the crisis. In fact, before the crisis hit, bills for financial reform had already been submitted before the National Assembly. The proposals included several measures. First, the government would funnel badly needed capital to banks. Second, powerful restructuring would be launched, with the goal of completion of due diligence on merchant banking corporations by the end of January 1998, on banks by the end of March 1998 and on other financial institutions by the end of June 1998. And lastly, the Non-performing Asset Management Fund would be greatly expanded to launch the Korea Asset Management Corporation (KAMCO) so that in a short time period, the KAMCO would buy if possible, all non-performing assets from financial institutions.

3. Details of Restructuring Initiative[2]

8. In consultation with the IMF, the Korean government first went about liquidating merchant banking corporations that had been directly involved in triggering the financial crisis for their role of financing foreign exchange, and then completed liquidation of failing banks by September 1998. Since then, non-banking financial institutions except for merchant banking corporations were also subject to restructuring. This initiative led to a 20% decrease in the number of financial institutions from 436 in late 1997 to 348 in late July 1999.

3.1 Restructuring of the Banking Sector

9. The restructuring of the banking sector was begun with the preparation work in the Q2 of 1998 and carried out intensively from the Q3 of the year. This led to reduction of the number of banks from 33 in late 1997 to 23 in late 1999. The details of the restructuring are as follows.

10. For the first time, on June 29th 1998, measures to eliminate five non-performing banks that were Donghwa, Daedong, Dongnam, Gyeonggi, and Chungcheong were taken through P&A (the Purchase of assets & Assumption of liabilities). Under P&A, the government-designated bank buys debts and high-quality assets only, with non-performing assets bought by the KAMCO.

11. Along with the exit of the 5 banks, the banking sector restructuring was carried out in various forms including M&As, foreign investment promotion and capital increase. All in all, five bank M&As in the wake of the financial crisis took place as of the end of 1999. The Korea Commercial Bank and the Hanil Bank first agreed to merge in July 1998, followed by an agreement between the Hana Bank and the Boram Bank, the one between the Kookmin Bank and the Korea Long Term Credit Bank, the one between the Chohung Bank and the Bank of Chung Buk, and again the one between the Kookmin Bank and the Kangwon Bank. These succeeding M&As in the banking sector took place in 22 years since the Seoul Bank and the Korea Trust Bank merged back in 1976. The five M&As of course took place as part of self-help efforts by ailing banks, but to some extent, they were the result of the government's intent. The government demanded intensive restructuring of the merging banks in exchange for purchasing their non-performing bonds as a priority. In addition, the government tried to ensure that banks would recover financial soundness with capital input from the Korea Deposit Insurance Corporation.

3.2 Restructuring of the Non-banking Financial Sector (merchant banking, lease, securities, insurance, trust and etc.)

12. Restructuring of the non-banking financial sector took place as follows. Between the end of 1997 and July of 1999, the government-initiated restructuring efforts in this sector were made on a total 42

[2] (2000), Reflection on the Korean Economy of 1999 and Tasks Ahead, Samsung Economic Research Institute

institutions in the form of M&As, P&A and liquidation. Among them, 38 institutions ended up going under through liquidation and P&A. The higher number of liquidation in the non-banking sector than that of the banking sector can be attributed to the lower cost of liquidation, the less impact on the national economy and their worse financial condition.

13. The M&As in the non-banking financial sector took place as follows. First, in August 1998, Hannam Securities was acquired by Hyundai Securities, and in following November, Korea Guarantee Insurance and Hankuk Fidelity & Surety merged to become Seoul Guarantee Insurance. Then, in February 1999, Hyundai Merchant Bank was acquired by Kangwon Bank, and in the following October, LG Merchant Bank was bought by LG Securities.

Financial Restructuring taken after Financial Crisis (as of late July 1999)

Category	No. of Entities	Liquidation	Percentage (%)
Bank	33	10	30.3
Merchant Banks	30	19	63.3
Securities	36	6	16.7
Insurance	50	5	10.0
Trust	31	7	22.6
Lease	25	5	20.0

4. Answers to the Secretariat Questions[3]

4.1 Should competition law be set aside in the financial sector during a systemic crisis, on public interest or other grounds? If so, how should this be done?

14. The Korea Fair Trade Commission, in principle, does not have any dissenting opinions on the idea that even under a systemic crisis, competition law should be applied to the financial sector. Yet, we deem that emergency measures initiated by the government in times of a systemic crisis, for the sake of public interest and stability of the financial system, may be exempted from competition law. This is because that these types of emergency measures are usually taken through the enactment/amendment of laws and regulations, and Article 58 of the Monopoly Regulation and Fair Trade Act stipulates that legitimate conduct pursuant to other laws may be exempted from competition law.

15. Meanwhile, the KFTC makes it a rule to review laws and regulations to be enacted or amended by other regulatory authorities through consultation with the concerned authorities regarding their potential anti-competitive effect. This statutory review is also applied to the enactment/amendment of laws and regulations drafted to overcome an economic crisis. Therefore, the KFTC is entitled to review, regarding the anti-competitive effect, the laws and regulations that would serve as a legal groundwork for emergency measures to overcome a crisis, prior to their enactment or amendment.

[3] Mergers in the Financial Services [DAFFE/CLP(2000)/17] p185-190 (OECD, Sep. of 2000)

4.2 How should competition agencies apply general competition policy rules about mergers, anticompetitive conduct and state aid during a crisis? Is it practicable to apply failing firm doctrines to mergers as crisis actions?

16. As stated in the Question 1, the KFTC does not dispute the idea that even during a systemic crisis, the financial sector should not be exempted from competition law in principle, except for some cases.

17. For example, the KFTC exempted from its merger review the 5 bank M&As under the government initiative in the wake of the 1997 financial crisis as it deemed them as legitimate conduct pursuant to other relevant laws. That is, the KFTC saw the mergers as legitimate acts under the control of the Financial Supervisory Commission pursuant to the *Financial Industry Structural Improvement Act,* an emergency measure designed to overcome the 1997 crisis. Still, albeit an afterthought, the KFTC reckons that its review would not have determined the M&As as seriously anticompetitive, given the existence of multiple competing enterprises in the relevant market at that time.

18. With respect to merger review, Article 7 (2) 2 of the MRFTA explicitly states on "the merger with a non-viable company," which means the MRFTA has already incorporated a failing firm doctrine. In addition, as the provision above is applied to all industries including financial one, there is no dispute on the use of failing firm doctrine in reviewing bank mergers. However, to date, failing firm doctrine has never been employed to authorization of mergers between financial institutions.

19. Regarding cartel enforcement, under Article 19 (2) 3 of the MRFTA stipulates that cartel activities may be sanctioned that have been pursued to overcome an economic downturn. However, no cartels in the financial industry have been authorized for such purpose to date.

20. Meanwhile, financial aid as part of bailout plan for financial institutions including banks is usually regarded as a practice acceptable both at home and abroad with the following economic and legal grounds. First, bankruptcy of banks could trigger a chain-reaction bankruptcy leading to a breakdown of the entire the financial system. Second, the breakdown of the financial system would have a far-flung effect over Main Street. Lastly, under the deposit insurance system (or in the case of central bank lending), the government (or central bank) could directly suffer from a bank run.

4.3 What lessons may be learned from how competition authorities have participated in responses to the recent crises and to previous events such as the Asian financial crisis of 2007? Are there any experiences from past financial crises in which measures for emergency response to the crisis in the short term, like mega mergers in the financial and other business sectors, caused greater harm to the competition in the medium and long term?

21. The answer to this question will be dealt in details in the next chapter.

5. Changes in the Korean Financial Market after the Asian Financial Crisis in 1997 and its Implications thereafter

5.1 Bank Consolidation and Growing Market Concentration

22. With restructuring drive gripping through the financial industry, banks rushed to consolidate their operations, thereby leading to a high market concentration level. In fact, when you look at the average asset size of Korean banks, as of late 1997 when the financial crisis just struck, the figure for nationwide banks recorded a mere 30 trillion 194.6 billion won. However, the figure continued to increase thereafter to mark 89 trillion 237.5 billion won in late 2003, almost a triple that of late 1997.

Changes in Bank Asset Size

(Unit: one billion Korean won)

Year	No. of Banks	Total Asset	Average Asset per Bank
1997	16	483,113	30,194
1999	11	506,786	46,071
2001	9	494,307	54,923
2003	8	713,931	89,237

* Source : 「Bank Management Statistics」, Financial Supervisory Service, each year's edition

23. Banks' growing asset size and their consolidation raised the market concentration level in the banking industry. As seen in the table below, the combined asset of top 3 banks was just 32.5% as of 1997 whereas in late 2003, the figure notably soared to 57.9%. Especially, the CR1, referring the level of market concentration of top 1 bank, nearly tripled during the period from 11.8% to 30.5%

Changes in Market Concentration Level in Banking Industry

(Unit : %)

		1997	1999	2001	2003
Asset	CR1	11.8	16.4	24.9	30.5
	CR3	32.5	43.4	51.1	57.9
Withholding	CR1	10.6	16.3	25.8	30.2
	CR3	31.5	43.9	52.3	59.3
Loans	CR1	11.3	17.1	35.2	32.3
	CR3	33.0	47.4	61.6	60.5

* Source : 「Banks Management Statistics」, Financial Supervisory Service, each year's edition

5.2 Impact of Bank Consolidation on Efficiency and System Stabilization

5.2.1 Efficiency

24. Jeong and Kang (2006)[4]conducted an empirical analysis of the effect of bank consolidation via mergers and holding company system on bank efficiency in terms of cost and profit, using data on Korea's banking industry between 1994 and 2005.

[4] Researchers with the Institute for Monetary and Economic Research of the Bank of Korea (2006), The Effect of Bank Consolidation and Increased Market Concentration on Bank Efficiency, BOK Institute Working Papers No.274

25. The empirical analysis noted that when it comes to cost efficiency, it has been improved in the wake of consolidation or integration through holding company system, but a direct cause-effect relationship has yet to be found. In other words, in both models, which were employed to indicate cost efficiency, the one using "labor cost/total asset" ratio and the one using "operating cost/total asset" ratio, mergers or integration through holding company system enhanced cost efficiency. But this is the result without controlling the net period effect in both models. In fact, with the net period effect controlled using year dummies, there was no improvement in cost efficiency made by mergers in both models. What this means is that there were factors other than mergers which raised cost efficiency of the banking industry in Korea.

26. In contrast, mergers or integration through holding company system was found to have made a statistically significant and positive improvement in profit efficiency of banks. That is, regardless of variables - whether it was "(interest income - interest expense)/total asset" or "(gross profit – operating cost)/total asset" – as an indicator of profit efficiency, and with/without controlling the net period effect, mergers or integration through holding company system proved to have affected profit efficiency to some statistically significant and positive degree. This increase in profit efficiency is thought to have been made by banks' enhanced profit-generating capability through mergers, but also influenced in large part by the post-merger banks' increased market power and reduced competition in the concerned market. Plus, the increase in market concentration was reckoned to have significantly positive effect on profit efficiency of other banks which were not part of the mergers. In other words, the effect that market concentration had on profit efficiency seemed to expand in a statistically significant and gradual manner over a certain level (about the level of concentration of the banking industry in Korea since 2000 or 2001). This suggests that mergers between banks have improved not just profit efficiency of banks involved in the mergers but also since around 2000, they have enhanced profit efficiency of other banks not participating in the mergers due to the increased market concentration via mergers.

5.2.2 System Stabilization

27. It is hard to tell whether bank consolidation and the ensuing heightened market concentration will be able to enhance stability of the financial system over the long term. True, mega banks' market power and their economies of scale and scope might help reduce the possibility of bankruptcy and furthermore raise stability of the financial system over the long term. However, in case individual mega banks fail to raise management efficiency and especially to achieve portfolio diversification which might reduce potential risk, it is hard to expect bank consolidation leading to stabilization of the financial system.

28. With respect to this, Kim (2003)[5] conducted an empirical analysis of bank consolidation on financial system stabilization in Korea. According to the analysis, banks' financial soundness indicators for asset quality were found to have little to do with scale variables associated with consolidation like credit increase rate or market power of individual banks. Next, an empirical analysis of banks' bankruptcy risk evaluated by the stock market showed that market sees that Korea's banks are relatively more susceptible to failure due to their risk-seeking asset management based on their strengthened market power through consolidation.

6. Conclusion

29. Korea's financial restructuring drive launched after the Asian financial crisis, in tandem with clean-up of failing banks, liquidation of non-performing loans, and corporate restructuring, is reckoned to have achieved its given missions- overcoming of the crisis and revitalization of the economy.

5 Hyeonwook Kim(2003), Bank Consolidation and Financial Risk of the Korean Banking Industry, Korea Development Institute

30. Currently, as it is, the market structure of financial industry does not seem to pose a concern. Yet, just in case, restructuring efforts that would occur in the future aiming at overcoming a crisis need to be guided over the long term in a direction that may not raise concentration in the banking industry to a seriously high level. That's because bank consolidation as a result of financial restructuring might cause a structural problem of an increase in market concentration. Particularly, as mentioned above, where mergers between banks raise not cost efficiency but profit efficiency alone through an increased market power and reduced competition, they could lead to undermining consumer interests over the long term.