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Corporate Workouts in Korea:

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I. Systemic Crisis Situation in 1997-98

1. The currency crisis in the late 1997 was the event that revealed whole economic problems in Korea. On the one hand real economic growth could not be sustained as the corporate sector had become less and less profitable ever since the early 1990s. On the other hand financial sector was distorted toward inefficient resource allocation.

2. More problematic was lack of understanding about the seriousness inside policy making circle. Even though Korean government launched the Presidential Committee for Financial Reform (PCFR) a year ahead of the crisis, PCFR were not fully aware of the upcoming risks. In addition, financial supervisory authorities did not figure out the distress level and risks of financial institutions. They even tried to advocate banks with regulatory forbearance measures against the criticism that Korean banks were in serious danger.

3. Both real and financial sector imbalances put pressures on the Korean currency that seemed to be overvalued as exports shrunk due to diminished world demand on the major Korean merchandise such as semi-conductors, chemicals, steels, automobiles, etc. On top of that, the mid 1997 currency crises in neighbor countries like Thailand, Indonesia, and Malaysia and international capital attack on Hong Kong dollar enkindled the Korean Won sell-off in November 1997.

4. The shock influenced immediately and deleteriously on the financial system. Financial markets were in tumult. Stock and bond price nose-dived (see Figure 1 below) and numerous insolvent debtors occurred. As debtors became delinquent, financial institutions faced with bank run pressure due to their own insolvency. Briefly put, both debtors and creditors were at a stalemate.

II. Korean Corporate Workout Structure

5. The corporate workouts in Korea was initially prepared for restructuring financially unhealthy medium sized *chaebol* companies, especially targeting for 6-64 largest conglomerates in asset size. The workout program was based on voluntary agreement (the Agreement hereafter) on promoting corporate debt restructuring among domestic creditor financial institutions in June, 1998.

5-1. In contrast, the top five *chaebol* companies that were relatively sound in financial

health were subject to government led restructuring, for example *Big Deal*, or business swap. As for large business groups, both top five and medium sized companies, other reforming measures have been taken such as debt equity ratio reduction, corporate governance improvement, accounting transparency strengthening, etc.

5-2. However, the Daewoo group, the second largest conglomerate in asset size, entered into corporate workout program later in 1999. It is this event that made the nature of the Korean corporate workouts clear.

6. The Korean corporate workouts is defined as not only a corporate sector restructuring program aiming at resolving corporate distress, but also a subsidiary one to support financial sector restructuring. As a matter of fact, the latter objective was in forefront, for a priority of policy considerations should be given to rescuing hard-hit financial system by the currency crisis.

6-1. In general, financial institutions produce semi-public goods, whereas individual companies private ones. If financial system does not function properly due to bank failures, no one is willing to bear the costs except for government, even though the entire nation would be beneficial to its resumption.

6-2. Because of market failure in public goods sector after the currency crisis, the imminent policy was rightly focused on rehabilitating banking sector, including deeply problematic merchant banks, and then non-bank financial intermediaries such as securities, life insurance and investment trust companies.

6-3. Financial restructuring was involved in disposing of non-performing assets and other business restructuring. During this process, financial institutions should incur so huge losses that they could not absorb with their own capital. Non-viability of financial institutions, which were major creditors to workout applicants, forced to define the properties of the Korean workout program as a part of financial sector restructuring by the end of the first half of 2001.

7. The workout program in Korea is evaluated as being semi-formal, instead of being informal, in terms of policy-making structure. Officially, it is creditors committee that determined to convert original debt covenants to new ones. Practically, the Corporate Restructuring Coordination Committee (CRCC), a mediator that creditors established in order to resolve technical problems in the process of negotiation, played critical roles in preparing for every detail in the new contracts.

7-1. Though consisting of private members, CRCC had close ties with Financial Supervisory Commission (FSC) that was a control tower orchestrating both financial and corporate sector restructuring. CRCC and FSC collaborated each other in the architecture of debt reduction such as the amounts of write-offs, maturity extensions, debt-equity swap, etc., because its size would be in tandem with the amounts of recapitalization of creditor banks by

the Public Fund.

7-2. Government involvement in corporate workout processes was inevitable in view of depth of corporate and financial sector distress. Under the circumstances where banks were subject to considerable risks of closure, their optimal behavior should be passive in corporate restructuring, which could result in their insolvency or illiquidity.

7-3. Government intervention became increasingly important after 12 Daewoo subsidiaries joined the workout program in the mid 1998. Their total debts to creditors under the program amounted to about KRW 70 trillion, or 58.3 billion US dollars, including guarantee liabilities. If the discount rate, 64.5%, was applied based on KAMCO's average acquiring price, 35.5 cents per dollar, KRW 45.2 trillion, or 37.6 billion US dollars, should attribute to losses of financial institutions. It was not the size of the losses that they could recognize without help of government.

7-4. Lots of arguments are still made regarding whether the Daewoo subsidiaries should have been under the workout program. Note that Korean workout program was less concerned about business rehabilitation. Rather, it was prone to loss minimization and amortization of loss-incurred financial institutions. In view of the loss size, it is out of question that Korean government could not help using the workout program to contain the Daewoo failure.

III. Incentive Problems and Resolution Methods

8. In the course of corporate workouts, various kinds of moral hazard took place. Some of the examples are as follows.

8-1. Debtor side: First, many largest shareholders of distressed companies were not cooperative with creditors in order to hold management because they would have been prosecuted and/or litigated for previous misbehaviors unless they had been in office. Second, the original owners of distressed companies, whose capital were reduced down during debt restructuring, tried to repurchase the controlling shares after the creditors agreed to write off part of their debts and/or to reschedule redemption.

8-2. Creditor side: First, outside creditors of the Agreement tried to share the benefits from the workouts without bearing any costs. Second, major creditors tried to take positions of the restructured companies in order to host their retired employees. Third, junior claim holders exercised hold-out against agreed-upon restructuring plan in order to receive more concession from senior creditors.

8-3. Government side: In general, government has multi policy objectives such as macro economic growth, full employment, and economic and financial stability as well as micro corporate and financial sector restructuring. These objectives are not always consistent each other so that government tends to be dynamically inconsistent (so called *time*

inconsistency problem). In other words, corporate sector restructuring, once defined as liquidating inviable companies and rehabilitating viable ones, may not be implemented depending on domestic and international economic situations. Korean government was not an exception in this context.

9. As experiences were piled up, both creditors and debtors became professional and mature in dealing with incentive problems. Appropriate rules and criteria were introduced to control moral hazard. In fact, the culture under which corporate distress is resolved according to rules and standards seems to be the most valuable output in the Korean workouts.

9-1. Moral hazard is a rational behavior, though not socially desirable. If a system is to control moral hazard as low a level as possible, it should devise a mechanism where incentive compatible behaviors must be in line with the socially optimal results.

9-2. Due to lack of experiences about debt and business restructuring, every stakeholder had a very divergent position at the very outset. They had different measures about corporate accounting for distressed companies, so that the gap of their individual pricing on the relevant assets was too wide for them to nail down.

9-3. CRCC had played a major role in this area. It drew consensus on accounting standards from the creditors and standardized negotiation processes. It also established pecuniary penalty schemes on violators against agreed-upon plans. In case of hold-out problem, cram-down rule was introduced with 75 percent consent of all creditors in debt amounts.

9-4. However, the workout program had limitations on outside creditors of the Agreement such as government financial agencies like KAMCO, KDIC, KCGF, etc. Financial institutions were not free to participate in corporate restructuring due to their capital inadequacy level. Debtor companies exploited this weakness of the creditors, delaying their intervention in management. Time inconsistency problem caused by government could be hardly resolved by nature. These were fundamental constraints of the Korean workouts under systemic crisis.

IV. Practical Issues in Corporate Workouts

10. As in many other assets the fundamental question is how to price distressed companies, but the difference stems from difficulties to quote the price at which every stakeholder reach a consensus.

10-1. Pricing based on due diligence by the third party is a method employed for the purpose of obtaining objective and impartial valuation. Measurement problem, however, took place since the stakeholders were suspicious of accounting standards used by the third party, usually accounting firm, if they were not satisfied with the due diligence reports. Thus,

it was a primary task to standardize the accounting principles and practices in case of financially distressed firms.

10-2. The disparity between creditors and debtors about the price of inventory assets were most wide. For example, if a clothing company held ten thousand coats made a year ago as inventory assets, what would be the right discount rate for them? Obviously, the debtors who were on the verge of risks of capital curtailment insisted on lower discount rate, whereas the creditors who would like to force out the incumbent management tried to apply a heavy discount rate.

10-3. CRCC mediated both parties to build up unified accounting standards. If a coat is three month old, the discount rate is 50%, If one year old, it is 80%, say.

11. Fresh cash injection is critical for distressed companies to be back in normal business even after debt forgiveness is offered. But after the workout program is initiated, it is obscure where the seniority of the new loans is located. For the member creditors of the Agreement they are treated as the first priority claim, but are junior to other non-member creditors'. This means that new loans are classified as below par-value credits immediately by their supplying banks so that even the member banks are reluctant to sacrifice.

11-1. Under these circumstances, it is utmost important for participating financial institutions to share prospective vision for the worked-out companies. If the companies are viable for sure, creditors are willing to lend more in order to maximize the total recovery.

11-2. Unfortunately, most Korean distressed firms were not in this kind of situation. It was the so-called Main Bank that arranged additional funds with which the debtors utilized employment and business restructuring. Actually, the Main Bank exercised almost full responsibility for rescuing or liquidating problematic firms. Also, the Public Fund supported part of funds arranged by the Main Bank as a way of financial sector restructuring. By way of financial institutions, therefore, government had a legitimate right to enforce desirable structure from its perspective.

V. Performance Evaluation and Lessons

12. Out of 106 applying companies for workouts, 97 ones were accepted and their debts financially restructured by the creditors committee based on the Agreement. Total amount of debts within the workouts reached KRW 98 trillion (see Table 1 and 2 below).

12-1. In 1998, 83 companies applied for the workout program and 21 and 2 more companies did in 1999 and 2000, respectively. The number of manufacturing firms was the highest, 70. 17 Construction and 11 retail & wholesales then followed. Around two third of the debt amounts under the program was attributable to 12 Daewoo subsidiary companies.

12-2. Interest forgiveness, KRW 20.9 trillion, such as maturity rescheduling from short-

term to long-term and reduction in interest rates was the major vehicle in debt restructuring. However, substantial amount of principal payments, KRW 16 trillion, was relieved by way of debt-to-equity swap. In addition, KRW 9 trillion was supplied as fresh loans.

12-3. As of the end of 2001, 22 companies were under the program. This year 6 companies have graduated from the program successfully. There are 16 companies are still under way as of November 2002.

13. It takes more time to evaluate the performances of the Korean workout program because some of the applicants are still collectively managed by the creditors based on the Corporate Restructuring Promotion Act, a successor to the Agreement. Furthermore, most of debt reduction and debt-to-equity swap were executed in the first half of 2001 so that we need more time to evaluate the performances by looking at turnarounds of the once distressed companies.

13-1. Nevertheless, from the creditors' perspective loan recovery rate increased through the workout program. The expected recovery rate is 50 to 70 percent, which is higher than the formal court advised restructuring. If liquidation had been forced on many insolvent and inviable firms at the very beginning of the crisis, the expected recovery rate would have been below 20 percent out of nominal debt amounts.

13-2. Along with the financial sector reform, the corporate sector restructuring including the workout program has contributed to asset price recovery and health of financial institutions (See Figure 1 and 2). If the Korean corporate workouts intended to support financial sector restructuring, it worked quite well.

14. Korean corporate sector maintains high debt level relative to GDP. Once reached to near 180 percent during the crisis era, it is now at 150 per cent. About 25 percent companies in terms of number and debt amounts are not profitable enough to make interest payments (see Figure 3 and 4). Therefore, Korean corporate sector still needs to be restructured.

Table 1. Financial Restructuring for Distressed Companies under the Korean Corporate Workouts

(As of the end of 2001)

(unit: KRW trillion)

Section	Amount of Debts	1st Round			2an Round		
		Debt Equity Swap	Interest Forgiveness	Fresh Loans	Debt Equity Swap	Interest Forgiveness	Fresh Loans
Daewoo Subsidiaries	62	5.3	19.7	6.3	N/A	N/A	N/A
Others	25	3.8	0.8	2.1	6.1	0.4	0.2
SMEs	11	0.4	0.0	0.4	0.4	0.0	0.0
Sum	98	9.5	20.5	8.8	6.5	0.4	0.2

Table 2. Companies under the Korean Corporate Workouts

(As of the end of 2001)

(unit: no. of companies, KRW)

Section	Applicants	Rejection	Workout	M&A	Success	Suspension	Under way	Amount of Debts
Daewoo Subsidiaries	12	-	12	-	4	1	7	62 trillion
6-64 Group	49	5	44	13	15	6	10	25 trillion
Others	45	4	41	3	28	5	5	11 trillion
Sum	106	9	97	16	47	12	22	98 trillion

Table 3. Non-performing Loans of Financial Institutions in Korea
(As of June 2002)

(unit: KRW trillion, %)

Section	Banks	Nonbanks	Depository	Insurance	Securities & ITC
Total Loans (B)	603.2	113.3		47.8	8.5
Substandard Loans (A)	14.2	11.8		2.2	3.9
Uncovered Substandard Loans (C)	7.3	3.7		0.9	1.2
Substandard Loan Ratio (B/A)	2.4	10.4		4.6	45.9
Uncovered Substandard Loan Ratio (C/A)	1.2	3.6		1.9	20.7

Figure 1. Stock Price and Interest Rates in Korea

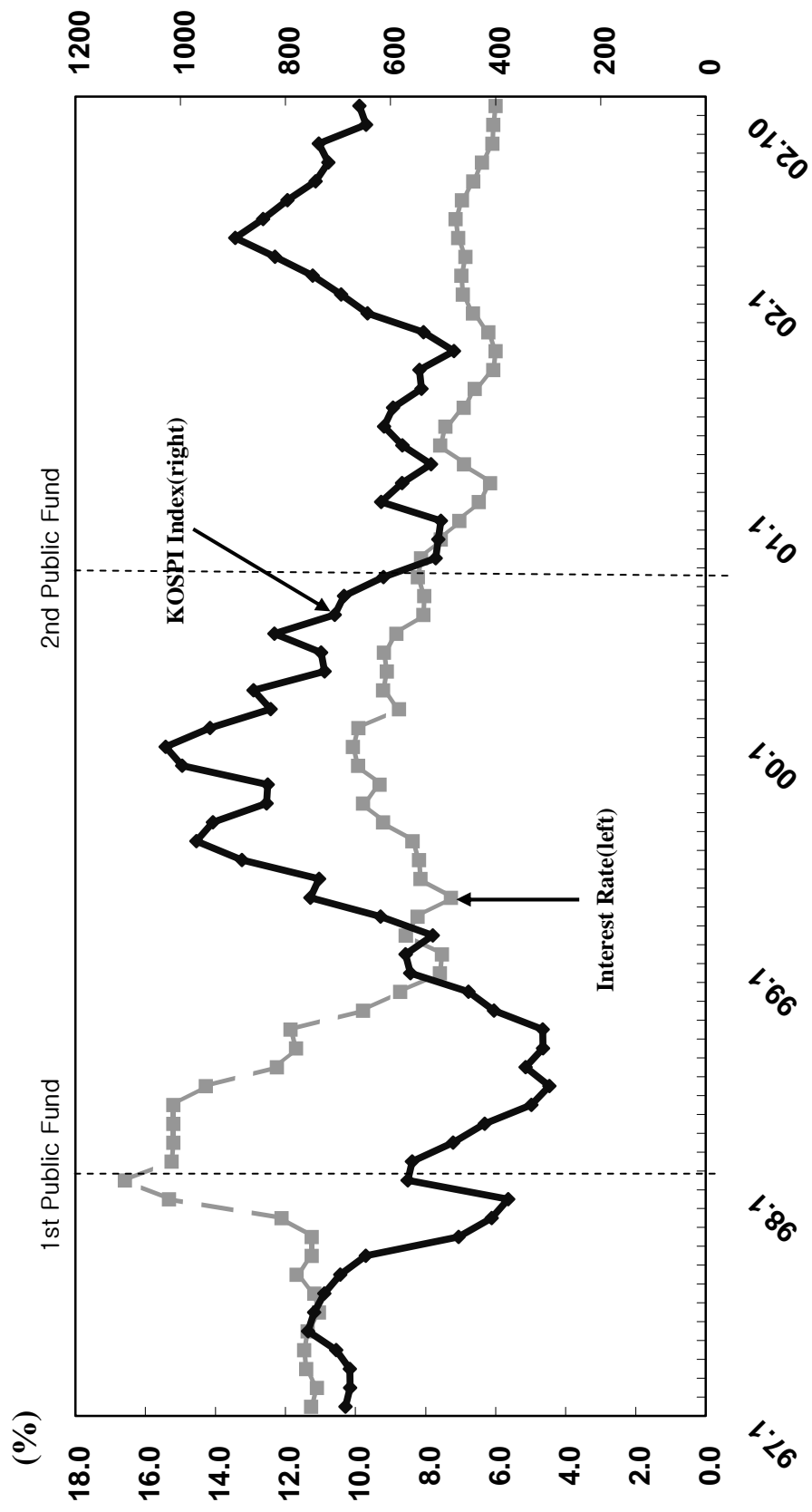


Figure 2. NPL Ratio and Capital Adequacy Ratio of Korean Banks

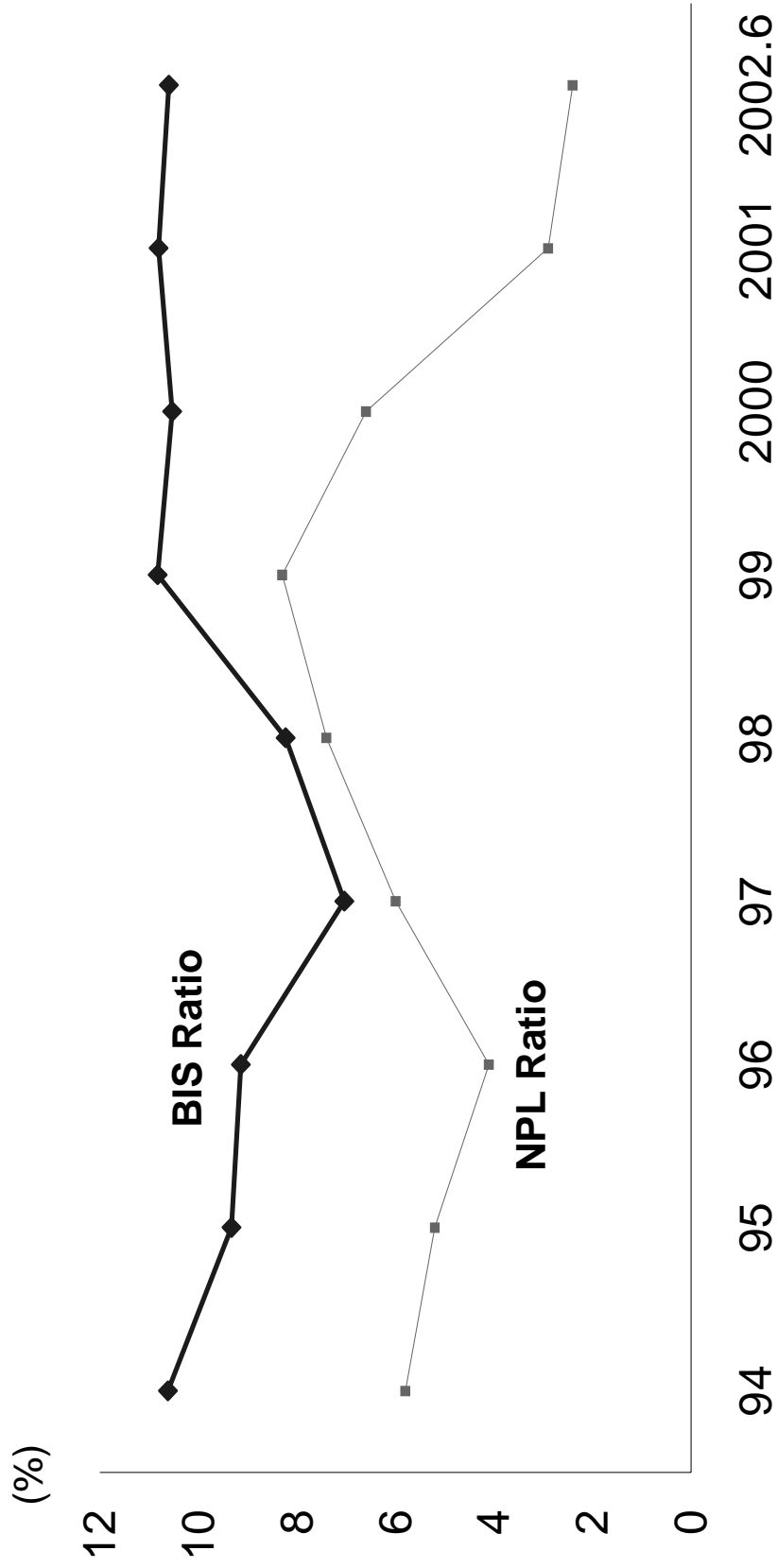


Figure 3. Time Series of Corporate Sector Debts in Korea

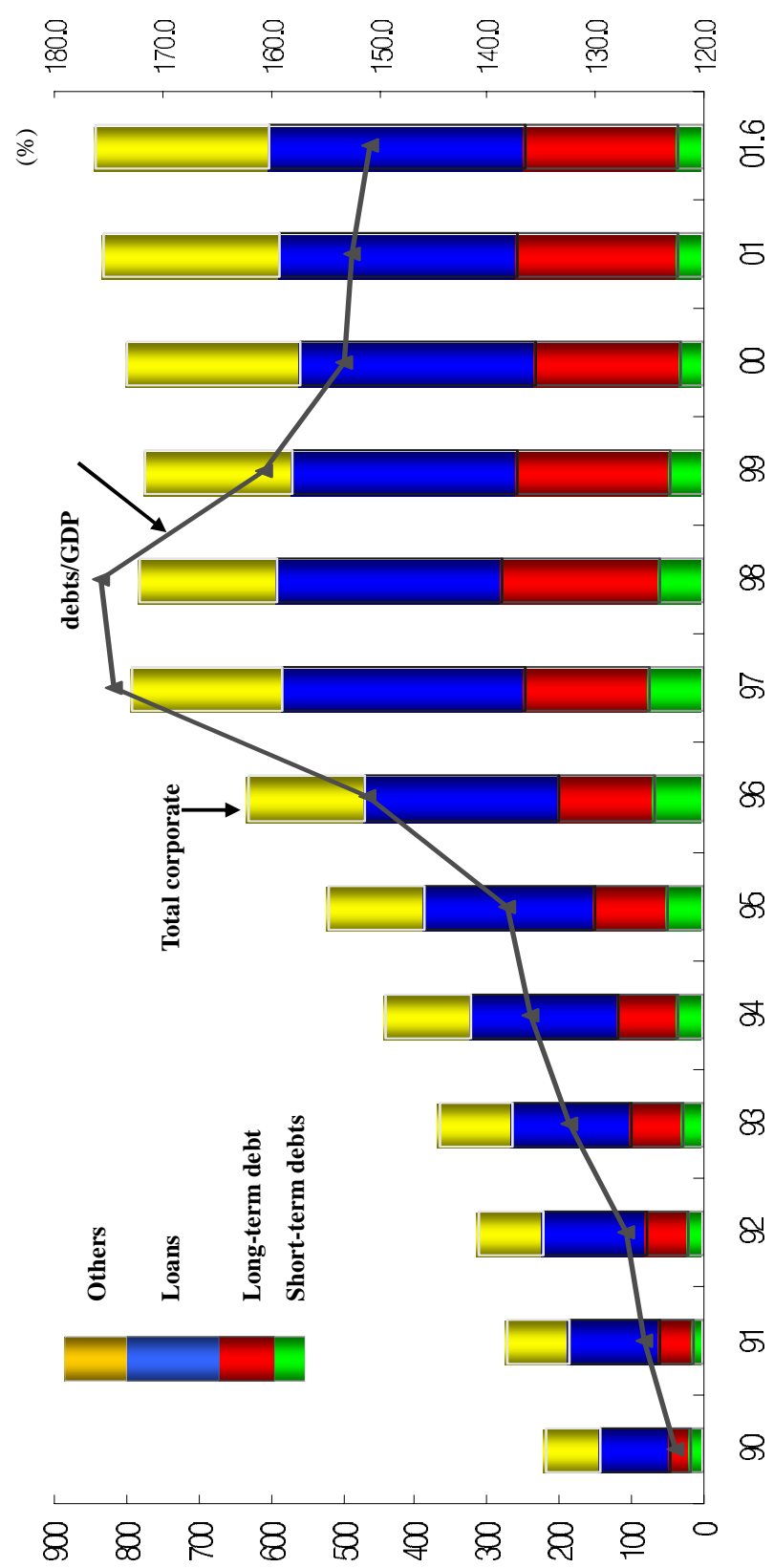


Table 4. Korean Stock Exchange Listed Companies whose EBIT < 1

