



**How the Consequences of the Asian
Financial Crisis of 1997-1998 Were Addressed:
The Experience of South Korea**

In the fight against the consequences of financial crises, governments around the world took various measures to stabilize the resilience of the financial sector.

One of the most successful cases in this regard is the experience of South Korea, which launched a government program for the restructuring of the financial sector in 1997 following the Asian financial crisis. An important component of this program was reducing the level of non-performing loans, which was entrusted to the Korea Asset Management Corporation (KAMCO), an organization similar to the Problem Loan Fund.

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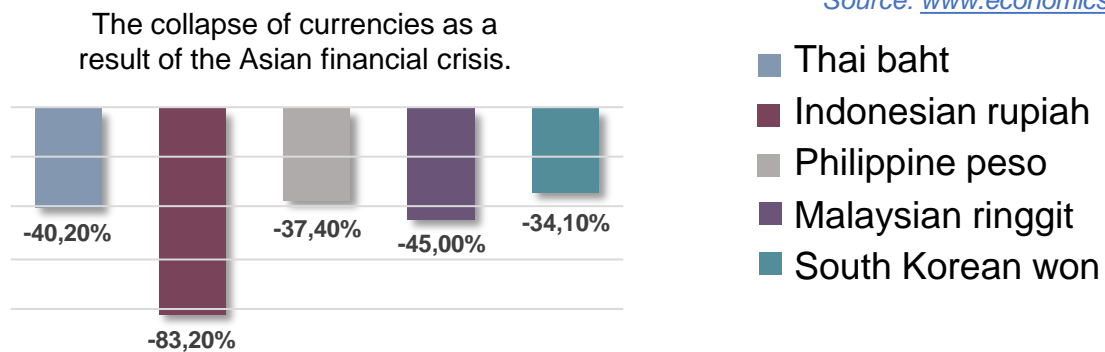
The Start of the Crisis. The Asian financial crisis began in Thailand, where in July 1997, as a result of the government's decision to float the currency, the Thai baht collapsed.

Almost immediately, a capital outflow from the region followed, triggering an international chain reaction. As the crisis spread, most Southeast Asian countries experienced a collapse in currency values, stock market devaluation, and a sharp increase in consumer debt.

The causes of the crisis remain a topic of debate. In the mid-1990s, Thailand, Indonesia, and South Korea faced a large current account deficit in the private sector, and the maintenance of fixed exchange rates stimulated external borrowing, leading to excessive exposure to currency risk in both the financial and corporate sectors.



When the U.S. economy recovered from the recession of the early 1990s, the Federal Reserve began raising interest rates to curb inflation. This made the United States a more attractive destination for investment compared to Southeast Asia, which had been attracting "hot" money flows due to high short-term interest rates, resulting in an increase in the value of the U.S. dollar. For Southeast Asian countries, whose currencies were pegged to the U.S. dollar, this caused their own exports to become more expensive and less competitive in global markets.



South Korea was one of the most affected countries by the crisis. Similar to Indonesia, behind high macroeconomic indicators were structural problems in both the financial and corporate sectors, which made the economy vulnerable to external shocks — primarily the financial crisis and sudden capital outflows. These issues included overdue repayment deadlines and currency risks, a weak financial sector, ineffective oversight and regulation, as well as a corporate sector with excessive borrowed capital.

Weak prudential regulation masked existing problems in the financial sector. Credit classification and provisioning standards, as well as accounting and disclosure standards (both for banks and legal entities), did not meet international standards, making it difficult to accurately assess risk. "Tolerance" from regulators was a common phenomenon, which made law enforcement opaque and undermined trust in the system. These problems were further exacerbated by the division of supervisory functions between the Bank of Korea (for commercial banks) and the Ministry of Finance (for specialized banks and non-bank financial institutions). In July 1997, rating agencies downgraded several Korean banks to the "negative" category due to concerns about declining corporate profits and the actual (compared to reported) level of non-performing loans in the system.



In this regard, in November 1997, the government announced that the acquisition of non-performing loans would become an integral part of the state program for the restructuring of the financial sector. Thus, the prompt resolution of the non-performing loan problem became an important component of the government's strategy to resolve the crisis.

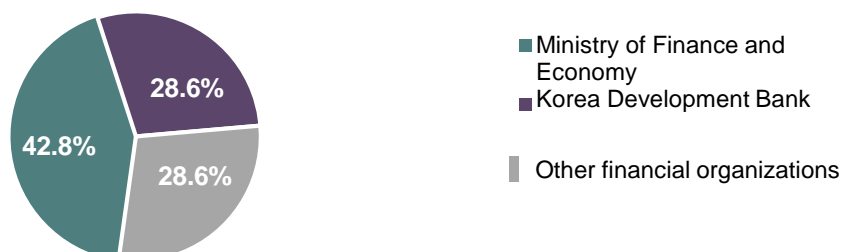
For reference: Prior to the crisis in South Korea, "non-performing loans" (NPLs) were classified as loans with a payment delay of 6 months or more. However, in 1998, classification standards were aligned with international practices, and loans with payment delays of 3 months or more were also classified as non-performing loans.

Launch of the NPL Resolution Program. Instead of creating a new organization, the Korean government preferred to assign the launch of the NPL reduction program to an existing organization – the Korea Asset Management Corporation (KAMCO). KAMCO was established in 1962 as a subsidiary of the Korea Development Bank (KDB) to liquidate the problematic assets of KDB. In 1966, KAMCO began acquiring non-performing loans from other financial institutions and gradually transformed into a specialized asset management company. Since the 1980s, the organization's activities were expanded to include the management and sale of state assets.

In November 1997, KAMCO was reorganized again in accordance with the "Act on the Effective Management of Non-Performing Assets of Financial Institutions and the Creation of the Korea Asset Management Corporation" (the KAMCO Act) into a public non-bank financial corporation under the control of the newly established consolidated regulatory and supervisory body – the Financial Supervisory Commission (FSC).

Source: KAMCO

Shareholders of KAMCO



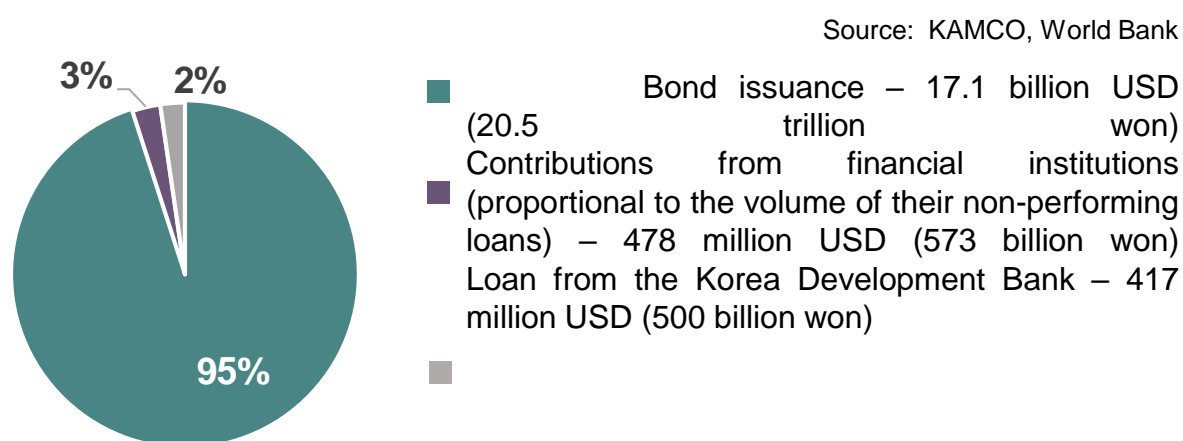


KAMCO's powers were focused on the acquisition, management, and liquidation of problematic loans. KAMCO was also tasked with ensuring the return of state funds through the effective management of the purchased assets.

In accordance with the requirements of the KAMCO Act, the resolution of non-performing loans was carried out through the Non-Performing Asset Management Fund (NPA Fund). KAMCO essentially acted as the manager of the NPA Fund, which had a separate legal status and other sources of funding. Although the law did not specify the duration of the NPA Fund's activities, it did limit the Fund's ability to issue bonds and purchase non-performing loans to a five-year period (i.e., until November 2002).

To enhance the effectiveness of dealing with non-performing loans, KAMCO was granted several special privileges, including exemption from taxes on financial transactions. Additionally, South Korea took a number of steps to improve its regulatory framework related to corporate restructuring. For instance, in 1998, amendments were made to three bankruptcy laws to expand the rights of creditors, ensure an out-of-court restructuring process, and simplify and accelerate the procedures for the liquidation and bankruptcy of distressed companies.

The main source of financing for the acquisition of non-performing loans was the issuance of government-guaranteed bonds. KAMCO raised a total of 18 billion USD (21.5 trillion won) through:



KAMCO bonds typically had maturities ranging from one to five years, with a combination of fixed and floating coupons and a market-based interest rate.

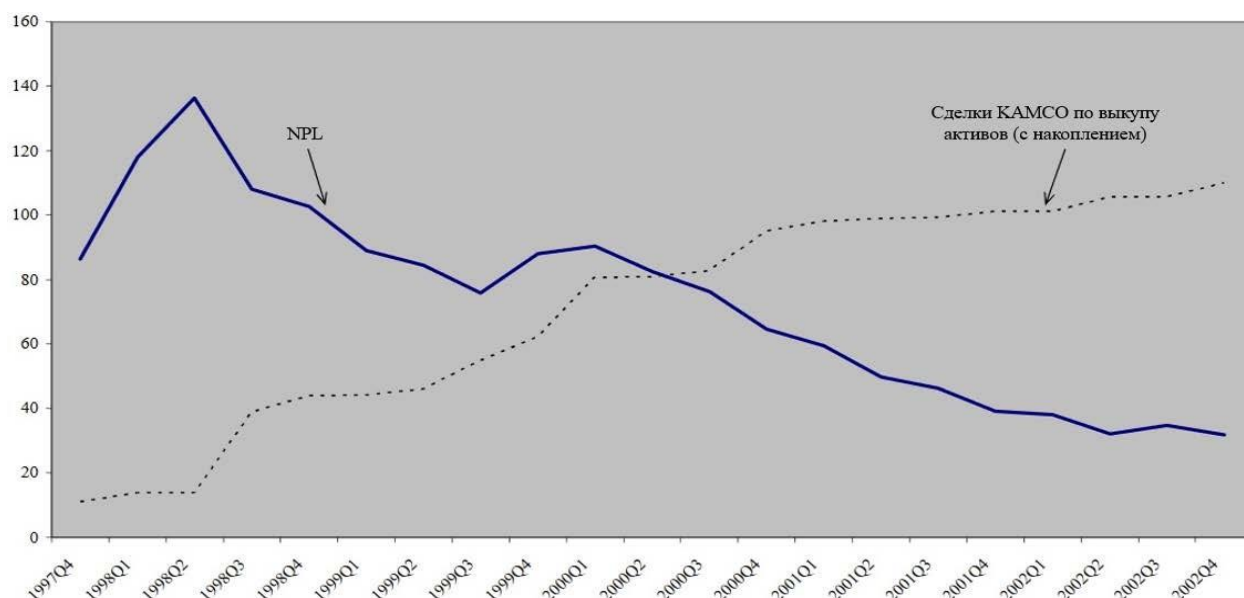
Asset buyback. According to the strategy adopted by the government, 50% of non-performing loans in the system were to be restructured by the financial institutions themselves, while the remaining 50% were to



be purchased by KAMCO. This strategy proved effective, and the level of NPLs began to decrease quite rapidly.

Source: FSS Weekly Newsletters, KAMCO

Dynamics of the NPL level in the financial sector.



KAMCO was authorized to acquire assets not only from banks but also from other financial institutions. Priority was given to the buyback of non-performing loans whose disposal was deemed critically important for the recovery of the selling institution, as well as non-performing loans with multiple creditors.

Source: KAMCO, World Bank

Selling organizations	Nominal value, billion USD	Purchase price, billion USD
Banks	51.52	20.6
Commercial banks	2.92	1.35
Insurance companies (guarantee insurance)	5.88	1.46
Insurance companies (life insurance)	0.25	0.06
Brokerage companies	0.12	0.07
Mutual savings banks	0.44	0.18
Foreign financial institutions	4.18	1.75
Organizations restructured by KDIC	5.65	0.7
Investment trust companies	18.58	6.99
Other	2.22	0.01

The acquired assets were classified by KAMCO as follows:

Source: KAMCO, World Bank

Classification of non-performing loans acquired by KAMCO	Nominal value, billion USD.	Purchase price, billion USD.
Ordinary loans – loans provided to functioning organizations (secured by collateral)	9	6
Ordinary loans – loans provided to functioning organizations (unsecured by collateral).	17	2
Special loans – loans restructured under bankruptcy proceedings under court supervision (secured by collateral).	22	11
Special loans – loans restructured under bankruptcy proceedings under court supervision (unsecured by collateral).	12	3
Daewoo Group loans	30	10
Workout loans – loans restructured under out-of-court rehabilitation programs.	2	1
Total	91.75	33.16

Asset valuation. The pricing methodology of KAMCO evolved over time. KAMCO began the process of asset acquisition in late November 1997. Due to the disruptions in the financial market and the need to act swiftly to stabilize the financial sector, KAMCO acquired assets in pools to expedite the process of asset acceptance and management.

Until September 1998, KAMCO used a methodology where the final purchase price of the acquired assets was subject to lengthy and contentious negotiations. The discount rates used in this methodology were roughly in line with the provisioning rates for loan loss coverage set by prudential regulations.



As the market situation stabilized, KAMCO gained sufficient experience to develop a more accurate methodology for valuing acquired assets. After September 1998, KAMCO began acquiring assets at a fixed price, calculated based on the specific characteristics and conditions of the loans. Additionally, sellers were given the option to decide whether to accept the price offered by KAMCO. The final calculated price of the asset could be adjusted through negotiations, but it would not differ significantly from the initially proposed price.

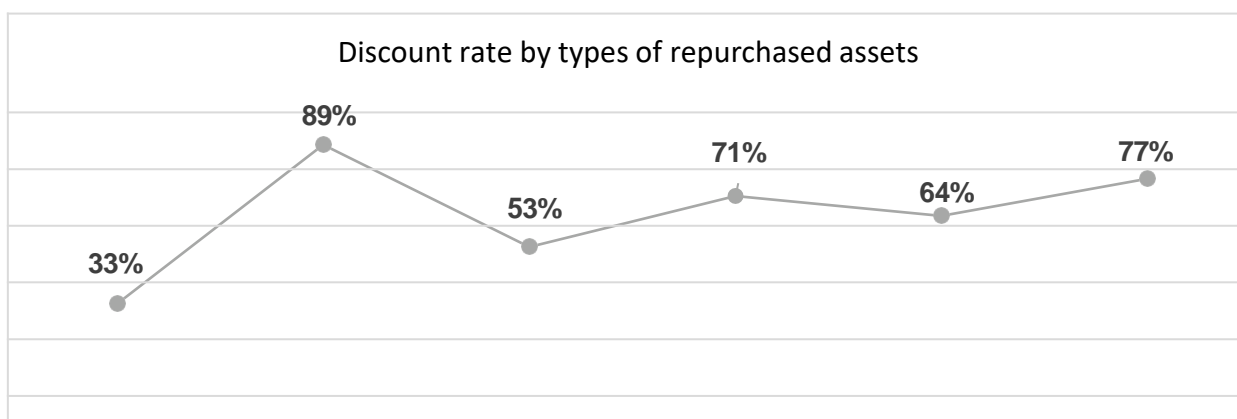
On average, KAMCO overpaid for assets acquired until mid-1999. Later, when the government adopted a more standardized market-based pricing mechanism, based on the discounted value of projected cash flows, prices became more realistic, promoting the development of the private market for distressed corporate loans.

Source: KAMCO, World Bank

KAMCO Pricing Methodology

Types of loans	Period	Pricing formula		Determining the final calculated price
		Secured loans	UnSecured loans	
Regular loans	Nov. 97 – July 98	70–75% Of the appraised value of collateral	10-20% of the nominal value	Договорная (постфактум)
	From Sept. 98	45% Of the appraised value of collateral	3% of the nominal value	Fixed
Special loans	Nov. 97 – July 98	70–75% of the nominal value	20-60% of the nominal value	Договорная (постфактум)
	Sept. 98 – June 99	45% Of the appraised value of collateral	-	
	From July. 99	NPV	-	Fixed

The average purchase price of assets was 36% of their nominal value, meaning the average discount was about 64%. However, the discount varied significantly depending on the type of loan: the highest price was paid for secured loans (33%), while the lowest was paid for unsecured loans (89%).



Regular Loans (Secured)	Regular Loans (Unsecured)	Special Loans (Secured)	Special Loans (Unsecured)	Daewoo Group Loans	Workout Loans
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It should be noted that the final amount invested by KAMCO in asset acquisitions was influenced by the government's directive to purchase Daewoo Group bonds, held by foreign creditors and investment trust companies, at an inflated price. Although the purchase price of these bonds was only 32.6% of their nominal value, the expected proceeds from recovery were much lower. This decision was politically motivated and aimed at preventing the default of one of the largest conglomerates in the economy.

Asset Management. In the early stages of KAMCO's existence, which coincided with the height of the financial crisis, the corporation's activities were primarily focused on acquiring assets and subsequently selling them quickly. Methods aimed at increasing the investment attractiveness of assets began to be applied only from 1999, as the macroeconomic environment improved.

Thus, in addition to traditional methods for dealing with distressed assets (recovery, restructuring, asset sales at auctions), KAMCO developed and successfully implemented innovative methods, such as asset pool sales, individual sales, and joint ventures. The choice of method depended on the characteristics and size of the asset.

Asset Pool Sales were typically carried out through the issuance of asset-backed securities (ABS) and the organization of international trading. This method had several advantages, as it allowed for the simultaneous settlement of a large number of loans, increased cash flows, and attracted foreign investments.



KAMCO conducted its first ABS issuance in 1999 on the domestic market and in 2000 on the international market through the eurobond market. As a result, it managed to attract well-known companies in the distressed asset sector, including Deutsche Bank, Morgan Stanley Dean Witter, Goldman Sachs, Cerberus Capital, and GE Capital.

In the same year, KAMCO expanded its activities in asset management by starting direct sales of non-performing loans and collaborating with both foreign and Korean investment companies that had specialized technology and know-how in asset management and corporate restructuring.

In the process of applying methods to enhance asset value, KAMCO contributed to the creation of a solid investor base in the newly established distressed loan market. Several banks followed KAMCO's lead and sold their distressed loans directly to foreign investors, including KAMCO's partners. The successful securitization of distressed loans through the issuance of ABS led to the development of the ABS market, supported not only by distressed assets but also by "healthy" ones, which in turn contributed to the further development of capital markets.

Performance Results. According to the World Bank's assessment, the overall performance of KAMCO can be characterized as "mixed" due to the high operational costs incurred by the corporation—averaging about 30% of the funds generated from asset disposals (for comparison, the U.S. Resolution Trust Corporation (RTC) had an operational cost ratio of 15%).

By the end of 2002, KAMCO's revenues from asset sales amounted to approximately \$3.2 billion, which was less than 50% of the aforementioned operational costs.

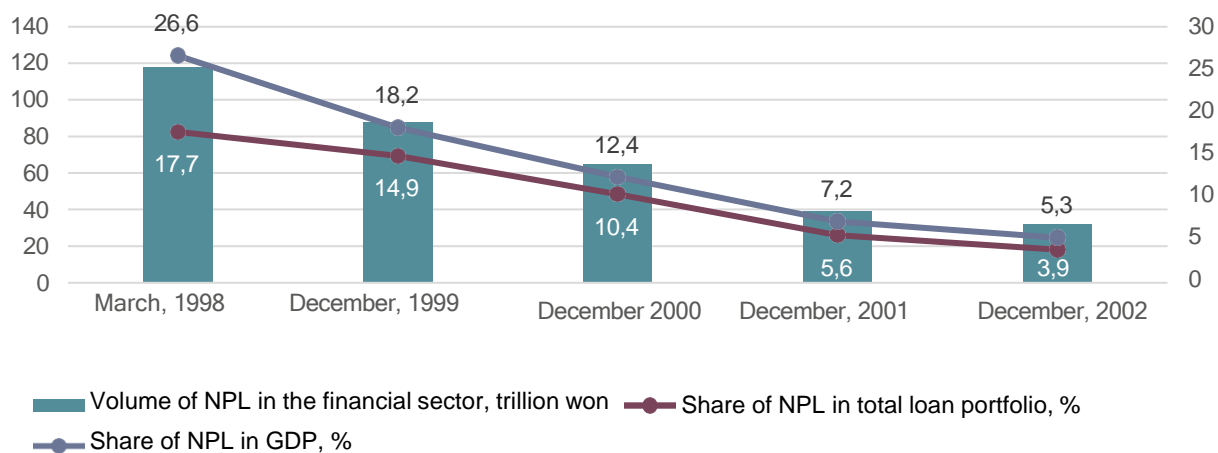
In total, the rate of return on funds invested in asset acquisitions was 46.8%.

On the other hand, KAMCO made a significant contribution to the establishment of the distressed asset market in Korea, providing banks and other financial institutions with new opportunities for more efficient credit risk management.

Additionally, as a result of KAMCO's activities in acquiring non-performing loans, the NPL level in the financial sector decreased from 17.7% (16.8% in the banking sector) in 1998 to 3.9% (2.3% in the banking sector) by the end of 2002.



Sources: Economic Bulletin, FSS Weekly
Newsletters and Monthly Reviews, Dong He (IMF)
Dynamics of the NPL Level in the
Republic of Korea from 1998 to 2002



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