Financial Restructuring through Financial Holding Companies

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Good afternoon, ladies and gentlemen,

First of all, let me express my congratulations on the 25th anniversary of ABA's foundation. I should like to voice my deep thanks to ABA for the invitation as a speaker on this meaningful occasion.

I would like to address you briefly on the progress in the restructuring of the Korean financial industry following the Asian financial crisis, and on the implications of the establishment and operation of financial holding companies as an effective means of structural adjustment in financing.

■ Financial Restructuring in Korea

After the financial crisis in Korea in 1997, more than 160 trillion won of public funds was injected into the restructuring of the financial industry, of which 54% was pumped into a total of 18 banks. Following this infusion of public funds, the financial industry itself undertook intensive efforts for restructuring. Through the merger or exit of ailing banks, the number of banks reduced from 33 in 1997 to its current 18.

In consequence, the Korean banking industry guided the formation of several large stable financial groups and mega banks. These financial institutions were enlarged in scale and are evaluated as having progressed to a global level through their management soundness and capacity for risk management. Having said that, we see that the Korean banking industry is still undergoing reorganization.

For example, the merger of former Shinhan Bank and former Chohung Bank gave birth to a new Shinhan Bank this April, which ranks second by asset size in Korea. As you are aware, Shinhan Financial Group was announced as the preferred bidder for LG Card, the country's second largest credit card issuer. Korea’s largest bank in asset scale, Kookmin Bank, is at present preparing for the acquisition of Korea Exchange Bank. In addition, from the year 2008, the "Capital Market Consolidation Act" is expected to enter into force. Under it the existing restrictions on ancillary business will be eased and we are likely to see the birth of professional financial investment companies covering the whole range of financial investment. This will obviously give rise to a whole new set of changes in financial products and financial markets.

However, the current restructuring differs from the wave of mergers and acquisitions just after the financial crisis, which was largely driven by healthy banks' acquisition of troubled financial institutions to bring about their turnaround. In contrast, the present wave of mergers is taking place between sound and well-run financial institutions with a view to achieving economies of scope and enlargement of scale.

■ Necessity of Financial Holding Companies

We can say that since the 1980s, the big story for the global financial industry has been universal banking and the creation of large-scale players. Leading global financial institutions have striven to achieve economies of scope by bringing banking, securities and insurance businesses under one umbrella, and economies of scale through enlargement. Banks in developing countries have generally gone along with this trend.

In the case of Korea, several large financial holding companies are already the market leaders. They include Shinhan Financial Group, Woori Financial Holding Company and Hana Financial Holding Company. These are still engaged in a drive to expand their scale and broaden their scope. The acquiring LG Card by Shinhan Financial Group, I mentioned above, can be a good example.

Besides this, in comparison to mergers between independent financial institutions, the process of merger between financial institutions under a financial holding company umbrella can be carried out very smoothly, making it easy to achieve economies of scale. To achieve its targets and strategic goals, the Shinhan Financial Group undertook preparations for almost two and a half years in order to bring about the integration of banking cultures and a readiness for the fusion between the former Shinhan Bank and the former Chohung Bank. Consequently their legal integration was achieved this April and, in contrast to previous mergers among banks in Korea, there were no visible or cultural hurdles in carrying this out. Following the merger, synergy effects are likely to emerge within a very short space of time.

■ Supervision and Systematic Support

If the financial holding company system becomes truly active, it is a good method of bringing about the strengthening of competitiveness and the enlargement of the scale and scope of financial institutions. To achieve this goal, it needs to be backed up through the strengthening of regulations that are appropriate in their level.

Firstly, firewalls need to be erected between the subsidiaries of financial holding companies so as to isolate and block off risk between them. Though, this runs counter to the basic idea of financial holding companies, which is to boost synergy effects between the subsidiaries, the ailing of one subsidiary could lead to the large-scale melt-down of the whole group and also weaken the foundation of the economy as a whole, particularly in South-East Asian countries, where financial institutions have a strong public character.

Korea has, consequently, opted to erect relatively strong internal firewalls within financial holding companies. The subsidiaries of a financial holding company cannot grant any credit to the parent holding company, nor can they hold shares in its other subsidiaries.

Where credit is extended from one subsidiary to another, collateral must be furnished and a claim must be established over it.

The establishment of such basic firewalls and their strict supervision to ensure compliance is seen to be necessary for the sound operation of financial holding companies.

Next, I would point out that if such firewalls are established and prudential supervision is exercised by the supervisory authorities, systematic underpinning needs to be given to heightening synergy effects and strengthening the linkages between various businesses, which are the principal grounds for the establishment of financial holding companies.

The banking, securities and insurance businesses brought together within a financial holding company need to be able to undertake the joint development and marketing of financial products through the linkages between them. The operating of integrated call centers or the opening of joint branches that can sell the whole range of financial products of each of the subsidiaries can be a good way to increase synergy effects by cost-cutting.

For this reason, the relevant legislation should be amended so as to allow the pooling of customer information among subsidiaries. To facilitate joint business operations, there should be a clear foundation for control concerning operating methods and basic regulations.

Last but not least, it is necessary to put in place a system that encourages financial holding companies to wholly own subsidiaries by holding 100% of their equity.

In the case of Korea, for a subsidiary to come under the umbrella of a financial holding company, at least 50% of its equity must be acquired, but obstacles may arise in decision-making and business promotion with regard to the integration effect of the group as a whole through conflict with minority shareholders regarding the operation of the subsidiary. In consideration of the efficient operation of the financial holding company, it is desirable for the subsidiaries to be wholly owned by the holding company.

■ Conclusion

By way of conclusion, let me just run through the main points of my argument once more.

The introduction of a strict supervisory framework involving firewalls between the subsidiaries is called for in order to avoid problems arising with regard to the financial soundness of the group.

To bring the system relating to financial holding companies into good order while retaining this basic framework, it is also necessary to bolster systems relating to the maximization of synergy effects by way of cost reduction and the promotion of profitability, which are the basic objectives of financial holding companies.

In particular, some form of incentive needs to be given to encourage financial holding companies to own 100% of the equity of their subsidiaries.

Admittedly, it is no easy matter to generate synergy effects while maintaining the strict supervision on financial soundness of the financial group as a whole.

However, in order that the foundation and running of financial holding companies does not simply become confined to the defensive strategy of turning round troubled financial institutions, we need to strive constantly for the well thought-out revision of regulations and for the development of supervisory techniques.

Thank you very much for listening so attentively.

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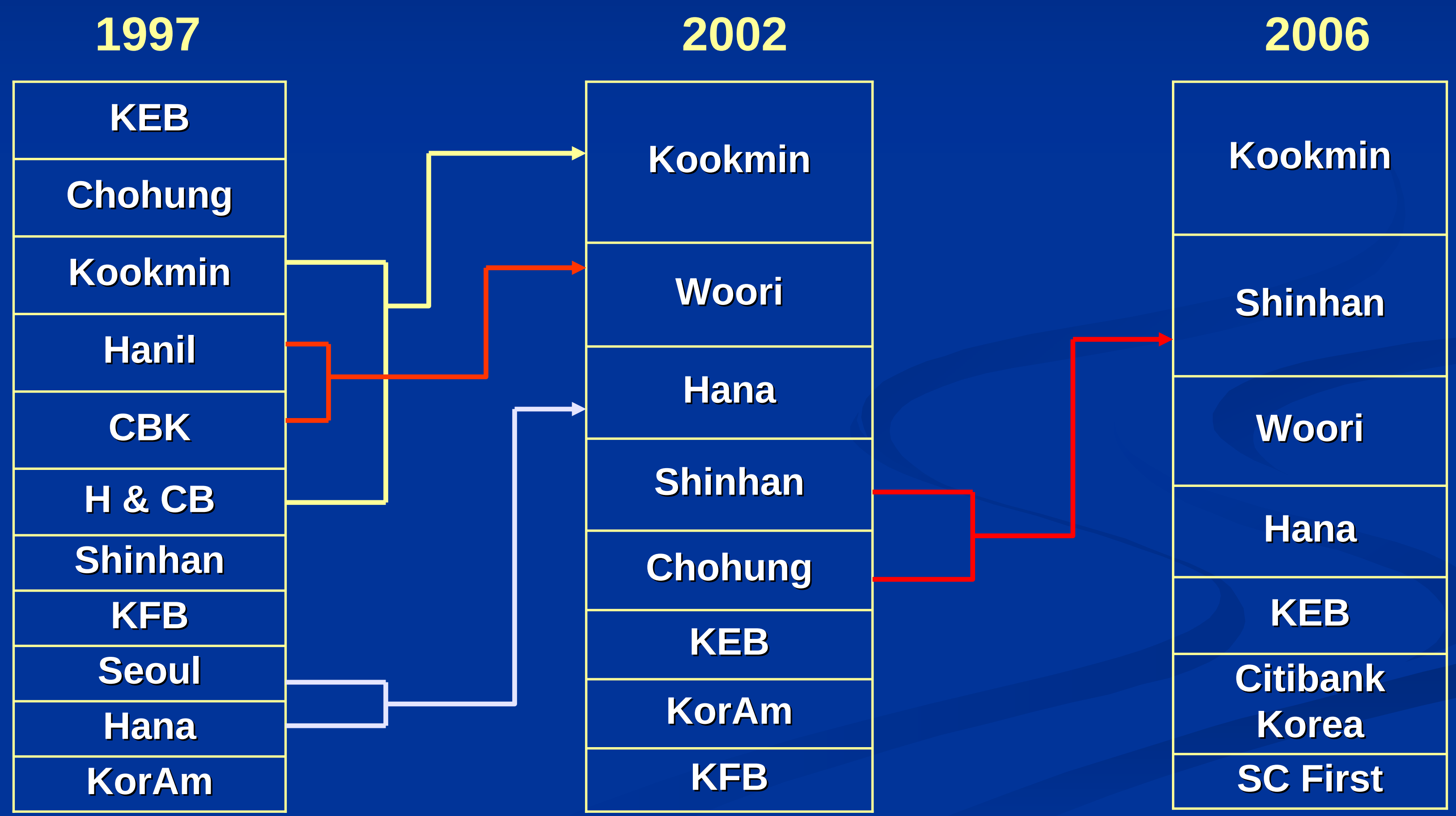
Financial Restructuring in Korea

Changes in Number of Banks

	1997		2006
❖ Total No. of Banks	33	►	18
❖ Number of Major Commercial Banks	11	►	7

Financial Restructuring in Korea

- **Restructuring of Major Commercial Banks**



Financial Restructuring in Korea

Ongoing Reorganization

- Integration between Shinhan and Chohung (April 1, 2006)
- Shinhan Financial Group, the preferred bidder for LG Card (August 16, 2006)
- Kookmin Bank's preparing for the acquisition of KEB
- Capital Market Consolidation Act (2008)

Changes in Restructuring Purposes

Acquisition of troubled financial institutions to bring about their turnaround	►	Merger between sound financial institutions to strengthen competitiveness

Necessity of Financial Holding Companies

- **Financial Holding Companies**

Banking + Securities + Insurance

▼

Universal Banking

▼

Economies of Scope

Economies of Scale

Supervision and Systematic Support

Prudential Supervision

Firewalls between subsidiaries

- To isolate and block off risk between the subsidiaries
- To keep the financial soundness of whole group and economy
- Cases in Korea
  - Prohibition on granting credit to the parent holding company
  - Restriction on holding shares of other subsidiaries
  - Restriction on extending credit to other subsidiaries without collateral

Supervision and Systematic Support

Systematic Support

Systematic underpinning for synergy effects

- Sharing of customer information among subsidiaries
- Joint development and marketing of financial products
- Integrated call centers or joint branches

Wholly-owned subsidiaries

- Strengthened operation efficiency of financial holding company
- Eliminating conflict with minority shareholders

Conclusion

- ❖ Well thought-out revision of regulations
- ❖ Development of supervisory techniques

- ❖ Strict supervisory framework – Firewalls
- ❖ Institutional support for joint business operation
- ❖ Incentives encouraging 100% ownership

- ❖ Maximization of synergy effects
- ❖ Financial soundness of the financial group